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LETTERS 2

CURRENTS 5
Let the Punishment Fit the Crime
Dying for Drugs
The Iceberg's Tip

REGULATION AFTER REAGAN 13
Roger G. Noll

MANDATED BENEFITS—ON THE AGENDA 21
Marvin H. Kosters

TELECOMMUNICATIONS POLICY IN THE REAGAN ERA 28
Robert W. Crandall

U.S. TRADE POLICY 34
William A. Niskanen

ENVIRONMENTAL POLICY 43
Richard L. Stroup

BANK AND THRIFT REGULATION 50
William S. Haraf

TRANSPORTATION POLICY 57
Thomas Gale Moore

READINGS 63

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Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitation, letters are subject to abridgment.

Paying for Power

TO THE EDITOR:

In anticipation of the U.S. Supreme Court's hearing of *Duquesne Light Company* v. *Barasch*, Michael McConnell argues for a return to "fair value" ratemaking for public utilities. ("Public Utilities' Private Rights," *Regulation*, 1988 Number 2.)

While I agree with McConnell that the "prudent investment" rule encourages overinvestment and that an aggressive application of the "used and useful" rule will encourage underinvestment, the "fair value" rule is not a real alternative. Indeed, traditional cost-based ratemaking must be overhauled radically, if not dispensed with completely.

The fair-value rule first articulated in *Smyth* v. *Ames* (1898) was skewered by Justice Brandeis 65 years ago because it was too speculative. In *Federal Power Commission* v. *Hope Natural Gas* (1944), the Court developed the balancing test referred to by McConnell and thereby, quite properly, took itself out of the state ratemaking business.

The Duquesne case, like Wolf Creek before it, is simply the wrong case to restructure either the process or the substance of public utility ratemaking and it should be either affirmed or dismissed—the damages are *de minimis* and there is no unconstitutional taking. No argument can be mustered to say that courts should now, on an item-by-item basis, decide which costs must be included in a utility's rate base.

In *Nuclear Power Transformation* (Indiana University Press, 1987), I considered the specific question of who pays for canceled nuclear power plants. A review of scores of cases, mostly at the state level, indicates that all public utility commissions split the costs for canceled plants between ratepayers and shareholders—although in different measures. There is no real economic formula for splitting these costs. Instead, this is a pure policy judgment regarding cost and risk allocation. Most states amortize cancellation costs, as McConnell describes. A few states, like New York, subscribe to the prudent-investment rule but will disallow imprudent investments, as in Shoreham. And a few other states, like Ohio, exclude a canceled plant from the rate base altogether. Even states that completely disallow a particular item, however, will permit an increase in the rate of return because of the increased risk faced by a financially weak utility, thus effecting some return to investors.

The electric power industry is entering a new era in which traditional public utilities must compete against other producers of electricity. The Federal Energy Regulatory Commission has issued a series of proposed rules that attempt to ease the transition into a more competitive environment. These proposed rules are being met with antagonism by every sector of the industry, and the new system will take some time to work itself out. Nevertheless, a return to the nineteenth century practice of having courts determine fair value will not ease the transition because that formula perpetuates an unnecessary and inefficient dependency on cost-based ratemaking. FERC proposes to create markets for trading bulk electricity so that electric rates are set by a competitive bidding process rather than in the hearing rooms of administrative agencies. FERC's proposals should be applauded because they move in the competitive direction with which, I believe, McConnell would agree.

Joseph P. Tomain
Professor of Law
University of Cincinnati
Cincinnati, Ohio

MCCONNELL responds:

I agree with Professor Tomain that the emergence of competition in electricity generation should be applauded and that traditional cost-based ratemaking should be allowed to wither. What he fails to appreciate is that the fair-value test, under modern conditions, can be a step in that direction. Unlike the fair-value rule "skewered by Justice Brandeis," which was based primarily on reproduction cost, the fair-value approach I advocate is based on avoided cost, as measured by the market value of electricity produced. It therefore allows the regulator to forgo reliance on historical cost data in favor of price information from competitive markets.

I will readily concede that my preference for this methodology is a policy judgment. I will even concede that the Supreme Court need not reach this question, that it is a judgment properly made by states, and that states may legitimately differ about it. The one thing I would insist on is that the policy judgment be made and revealed in advance of investments, and not revised in retrospect. If the Court finds this one constraint in the Constitution, states will be free to search for the best ratemaking methodology. Absent a constitutional constraint, however, the threat of *ex post facto* state politics will needlessly raise the cost of capital for regulated utilities and their ratepayers.

Michael W. McConnell
Professor of Law
University of Chicago
Chicago, Illinois

The Price as Right

TO THE EDITOR:

Michael E. DeBow's thoughtful criticism of my views on price cooperation ("What's Wrong With Price

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Fixing," *Regulation*, 1988 Number 2) warrants comment.

DeBow acknowledges that cartels may be inherently unstable in theory but argues that, in practice, they can be both long-lived and effective. He cites the electrical equipment conspiracy of the 1950s as an example. This conspiracy was certainly long-lived, but that does not mean it was stable. Indeed, it was the instability of the cartel that made it long-lived; the price agreements often lasted no longer than the meetings themselves, and new meetings had to be called. To note that there was a 10-year conspiracy in this industry does not make DeBow's point. It was the conspirators' inability to fix prices successfully that perpetuated the conspiracy.

DeBow's discussion of the effectiveness of conspiracy is naive. He cites a Federal Trade Commission study of the electrical conspiracy and an estimate by the U.S. Department of Transportation on the overcharge from bid-rigging in highway construction. Unfortunately, all such studies have serious methodological difficulties. There is simply no definitive way to determine what market prices would have been in the absence of collusion and, therefore, no definitive way to estimate "overcharges." In the electrical equipment cases, for instance, the court made unwarranted assumptions concerning the pre-conspiracy period, the level of demand and order backlog, the state of technology, and many other variables in order to arrive at its overcharge estimate and its multimillion-dollar fines. More reasonable assumptions would have produced no overcharge and a conclusion that the conspiracy was as ineffectual as it appeared to the businessman involved.

The alleged 2 to 5 percent overcharge to the states in highway construction cannot be cited as proof of anything in this debate. State governments—unlike private firms—have few incentives to "discover" collusive agreements or rigged bids. (Most of the alleged overcharges of the electrical conspiracy fell on the federal government.) With or without antitrust laws, state governments are free to change the manner by which they let contracts for construction and to boycott firms that participate in cartels.

The OPEC example is similarly unpersuasive. OPEC is a conspiracy of foreign governments, not private firms, that owed its "success" to U.S. price controls on crude oil and natural gas in the 1970s.

Even if private cartels were effective in raising prices, the issue of social desirability still would not be resolved. Disequilibrium prices often must rise as they move toward an equilibrium level. How can price fluctuations as cartels form and dissolve be distinguished from other adjustments in a dynamic economy? More important, if cartels can lower costs by more than they raise prices—or simply by more than they impose in deadweight losses—then they are a social bargain. DeBow does not directly refute the argument that cartels could lower costs, but cites criticism of Donald Dewey's analysis and dictums from Robert Bork. Unfortunately neither Dewey nor Bork in the writings cited examined actual cartel behavior to see whether there were cost savings. Those of us who have examined such agreements are not convinced that they are "naked" and devoid of social advantage.

DeBow is silent on the question of whether prohibiting price agreements violates rights. If I own my goods and you own yours, how do we violate anyone's rights by agreeing to fix our terms of exchange? If I have the full right not to produce at all (to compel production would be illegal servitude), why do I have no right to engage in "restricted" production? Most economists and attorneys are willing to limit an individual's liberty to agree on price with another, and they should be prepared to admit the trade-off and debate the question of rights.

Finally, my own view on the legal enforceability of cartel agreements is that mere promises ought not to be enforceable. Simple price agreements do not transfer title to real property; thus, a breach of the agreement does not amount to theft and does not violate rights. Firms that are "injured" by breach have simply exercised bad entrepreneurship and are not entitled to any legal remedy.

D.T. Armentano
Professor of Economics
University of Hartford
West Hartford, Connecticut

DeBOW responds:

Professor Armentano's restatement of the arguments concerning the effectiveness of past U.S. cartels misses my main point: that U.S. historical evidence does not tell us how effective cartels would be under his preferred legal regime of tolerance toward price fixing. He stresses that successful cartels tend to include governments in the role of organizer, abettor, or easy mark. This is fully consistent with the hypothesis that antitrust laws reduce the effectiveness of price fixing among private firms.

Armentano asserts that cartels reduce costs more than they increase prices. While this might be true of some cartels, the current rule of per se illegality would appear to be the more economical one until someone can demonstrate that the net benefits from cartel behavior exceed the social costs of requiring courts to apply a "rule of reason" benefit-cost test in price-fixing cases.

Finally, Armentano's "rights" argument continues to puzzle me. It seems to me that Armentano's conclusion that property owners have a natural right to enter into price-fixing agreements necessarily implies a right to agree that such agreements will be legally binding and enforceable. Why does Armentano not wish to grant this contract right, which would enable price fixers more effectively to exercise their property rights in the way they desire? Since he does not tell us, I am left with the impression that he is unwilling to follow his "rights" argument to its logical conclusion.

Professor Michael DeBow
Cumberland School of Law
Samford University
Birmingham, Alabama

The Golden Door

TO THE EDITOR:

Professor Chiswick's suggested revisions in U.S. immigration policy ("Legal Aliens," *Regulation*, 1988 Number 1) seem unnecessarily harsh for two reasons: First, separation of families should require extraordinary justification. Restrictions on immigration are necessarily limits

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on the exercise of individual freedom of choice and the general freedom of peoples to emigrate—restrictions that we, as a nation, have deplored when applied by totalitarian states. Congress's choice of kinship ties as significant in granting permission to immigrate here recognizes a strong and legitimate constituent interest—the desire of families to live together, whether or not they conform to the Western, suburban, nuclear family model.

Second, investors and other needed workers should be able to be accommodated without undue restriction, given the current economy. Unemployment rates nationwide are the lowest in 14 years. While the current rate of job creation cannot be said to provide certainty about the future, it suggests that the U.S. economy has the capacity to accommodate more immigrants than we now let in legally, given the slower rate of workforce increase our aging population will produce over the next couple of decades. Adjustment of immigration policy to admit as many immigrants as can find work or create jobs would have beneficial effects on tax revenues, and would eliminate the many social ills of the underground economy associated with illegal immigration.

In sum, the economy appears likely to create sufficient jobs to accommodate both relatives and those willing to invest their money or skills in the United States. If Congress is to act, it should consider opening the door—not slamming it.

William A. Price
Attorney at Law
William A. Price & Associates
Wheaton, Illinois

"Shareholders are Revolting"

TO THE EDITOR:

Your panel discussion of corporate takeovers ("Corporate Takeovers: Who Wins; Who Loses; Who Should Regulate?" *Regulation*, 1988 Number 1) was timely and thoughtful. If, however, Professor John Coffee was correct in his statement that the panel agreed shareholders are not being abused, I think they were wrong. The discussion began with the assertion that the shareholders of acquiring firms lose out in takeovers. And I would argue that target shareholders lose as well, in the adoption of value-depressing antitakeover provisions (some, like the poison pill, without shareholder approval). This is possible because an integral part of the contract between those who provide the capital (shareholders) and those who provide the labor (corporate management) has all but disappeared, due to rampant inefficiency in the most important mechanism for shareholder communication—the voting of proxies. Simply put, the mechanisms for expression of shareholder opinion, principally voting, do not work. This is documented in *Conflicts of Interest in the Proxy Voting System*, a study by the Investor Responsibility Research Center.

One reason is the Byzantine structure of the system itself. Roughly 70 percent of all corporate stock is now held in "street name" (the name of the bank or broker), and held at a regional depository. If the investor does not want its name released to the company whose shares it holds, as is true of many large institutions, it is kept confidential. This makes it very difficult for any shareholder to identify, much less contact, the other shareholders. Corporations gather and count proxies with no supervision and no obligation to report the totals. The beneficial owners of more than a third of all stock are not even able to find out how the stock is voted on their behalf, so they have no way to evaluate the performance of their fiduciaries. The companies, on the other hand, do know how the shares are voted, enabling them to put pressure on the trustees.

Furthermore, there is the well-documented problem of collective choice and "rational ignorance." Shareholders, even large ones, can seldom justify the expense of thorough analysis, much less activism, for only a pro rata share of any return. And even when shareholders are successful in taking action, management may not have to abide by their direction.

As SEC Commissioner Joseph Grundfest pointed out, "After many years of neglect, the shareholders are revolting against a system that has not rewarded their risk and investment as well as it could have." They really have no alternative. The large institutional investors, projected to hold half the shares of stock in this country by the year 2000, are just too big to follow the traditional "Wall Street rule"—vote with management or sell the shares. Moreover, over 400 companies have adopted poison pills as antitakeover devices, despite empirical data showing that poison pills depress share value. An institutional investor cannot sell out of all of them. The adoption of state antitakeover laws and the change in the tax treatment of greenmail has pushed the battle for corporate control out of the tender offer and into the proxy fight, presenting shareholders with an increasing number of complicated and controversial decisions. This makes it all the more important that the proxy system work fairly and efficiently.

The SEC's recent adoption of the one share, one vote rule is an important step in maintaining management's accountability to shareholders. Public disclosure of proxy votes by institutions (currently proposed in California), independent monitoring of proxies, and more efficient transmission of the ballots would also make it easier for shareholders to evaluate their options fairly and act on them correctly. As Professor Roberta Romano noted in your panel discussion, "we focus on enhancing shareholder value because when looking at a corporation, it is difficult to conceive of who else's interests would be appropriate for determining the efficient allocation of resources in the economy." I suggest that if we let shareholders focus on shareholder value, they, particularly institutional investors, can function as watchful "long-term owners" essential for the competitiveness of American industry.

Nell Minow
General Counsel, Institutional Shareholder Services, Inc.
Washington, DC

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Currents

Let the Punishment Fit the Crime

What factors should a judge consider when a convicted criminal stands before him to be sentenced? And what if the perpetrator is not a real person, but an artificial person—a corporation? These questions are complex and case law has not produced consistent answers to them. Indeed, the wide disparity in sentences for comparable crimes prompted Congress in 1984 to create the U.S. Sentencing Commission and to charge it with drafting comprehensive federal sentencing guidelines.

The creation of the Sentencing Commission touched off a separation-of-powers controversy because it includes judges and non-judges in an agency nominally in the judicial branch, procedurally more akin to the executive branch, and engaged in an activity that is arguably legislative. The commission's guidelines for sentencing individuals convicted of federal crimes were issued in 1987, and already 250 federal judges have ruled on their constitutionality: 42 percent in favor; 58 percent against. The constitutional question is now before the Supreme Court.

Meanwhile a second controversy is brewing in the legal community over the commission's deliberations on guidelines for sentencing organizations—that is (almost always), corporations. A discussion draft of the guidelines was published in July, and the commission is presently holding a series of hearings on it. Some critics label the draft as soft on white-collar crime because it openly embraces an approach that seeks to avoid overdeterrence as well as underdeterrence, suggesting a benign tolerance of crime that has no place in the criminal justice system. Others argue that the penalties being discussed are so much more severe than current penalties that they will cause substantial economic damage and may go beyond the scope of the commission's charter.

Most participants in the debate agree that the financial penalty against a corporation should be commensurate with the offense. A central point of disagreement, however, is the metric for the severity of a crime: its benefit (to the perpetrator), or its cost (to society). Traditionalists stress that the appropriate goal for sentencing is to ensure that crime doesn't pay; economic pragmatists argue that the goal should be to ensure that crime doesn't cost. Although it is not immediately apparent, the economic approach is inherently more severe: the activities that we make criminal generally involve social costs much greater than the private gains, so that cost-based penalties make crime more than unrewarding.

The economic view is dominant in the draft guidelines. This approach, drawing on the law and economics literature of the past 20 years, holds that the goal of law enforcement is not to minimize crime per se, but to deter crime optimally and thereby maximize society's wealth. It argues that the expected penalty (the probability of punishment times the actual penalty) for any particular crime should equal the social cost, or harm.

The table below shows, for a sample of 159 cases decided between January 1, 1984 and December 31, 1987, the ratio of criminal penalties to the social harm that would be estimated using the guideline criteria. These ratios are shown both under current practice and under the proposed guidelines. (A penalty-to-harm ratio of 1 would be appropriate when the probability of punishment is 1; the lower the probability, the higher the appropriate penalty-to-harm ratio.) As illustrated, the mean ratio under current practice is 0.28. For the typical case of private fraud or property crime, the guidelines propose that the criminal penalty be raised to a multiple of 2 times the social cost, with a reduction to 1.5 if the particular crime is unusually likely to be detected, or an increase to 3.0 if the perpetrators acted to make detection more difficult. For the typical crime in all other categories, the multiple is set at 2.5, with a reduction to 2.0 or an increase to 3.5 depending on the ease of detection. Firms that voluntarily report their offenses

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prior to the commencement of an investigation would be subject to a multiple of 1.0.

The guidelines recognize that penalties should vary with the difficulty of detection. For instance, judges may increase the penalty if there have been active efforts to conceal an offense or its consequences, or reduce it if a firm has been unusually forthcoming. This allows for tailoring penalties to reflect the extent to which a firm's own strategic behavior increases or decreases the likelihood of detection.

The guidelines incorporate several other novel economic adjustments to the calculated penalties. For example, penalties are adjusted for the time elapsing between the time the social costs are imposed and the time the penalties are actually paid. Also the guidelines do not permit judges to adjust the size of a penalty to the size of the firm, or to limit penalties on corporations to prevent insolvency; an optimal penalty structure will periodically (and appropriately) render corporations insolvent.

What causes many prosecutors to object to the guidelines is the implicit notion that a corporation should be permitted to engage in crime when it perceives the act to be in its interest. They invoke the image of a board of directors weighing the pros and cons of committing a crime. At the commission's October public hearing in New York, for example, Gary G. Lynch, Director of Enforcement at the Securities and Exchange Commission, argued:

> To reach potential violators, prosecutors and judges have to convey a stronger message: that the penalties for detection and conviction will not only eliminate any gains to the violator, but will be perceived as sufficiently abhorrent that no reasonable person would even undertake an economic analysis of the risks and rewards of conduct.

This image is a red herring. Crimes are committed by agents of a corporation and, while corporations spend substantial resources to deter internal crime, they cannot be completely successful. It is impossible to be sure that nowhere in the organization will a safety standard be violated, an emissions limit exceeded, or a securities rule transgressed. Corporations will devote resources to deter crime to the extent it is in their—that is, the stockholders'—interests to do so.

In effect, the economic approach enlists the corporation as a law enforcement agent. Indeed, this is the most compelling rationale for subjecting "artificial persons" to criminal liability. A corporation is far better situated to control its agents than is any other law-enforcement organization. It can detect and deter crime cost-effectively through its personnel practices, compensation policies, accounting systems, security procedures, and other means available only to the corporation. It is certainly socially advantageous to encourage the corporation, as a law-

Ratios of Criminal Penalties to Social Costs Under Current Practice and Sentencing Guidelines
(For Sample of 159 Cases Decided 1/1/84-12/31/87)

Offense	Current Practice Mean Penalty/Mean Cost	Guidelines Min	Guidelines Typical	Guidelines Max	Increase in Penalty for Mean Case
Private Fraud	0.26	1.5	2.0	3.0	7.7 times
Government Fraud	0.39	2.0	2.5	3.5	6.4 times
Tax	0.07	2.0	2.5	3.5	35.7 times
Property	0.06	1.5	2.0	3.0	33.3 times
Environmental	0.51	2.0	2.5	3.5	4.9 times
All Cases	0.28		2.0-2.5		7.1-8.9 times

Derived from Mark A. Cohen, "Preliminary Assessment of the Impact of the July 1988 Discussion Draft on Corporate Monetary Penalties." A Report to the U.S. Sentencing Commission.

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enforcement agent, to act efficiently. Crime deterrence is unarguably a good, but it is also costly. Wasteful spending by corporations is just as socially undesirable as wasteful spending by a city police force or by the FBI.

The right image to have in mind, therefore, is not of a criminal performing a benefit-cost analysis to decide whether to commit a crime. Rather it is of a law enforcement agency performing a benefit-cost analysis to determine what resources to use in deterring crime and how best to deploy them. Part of the function of the cost-based penalties is to give a price signal to corporations that indicates the relative severity of various crimes. That way the corporation's efforts to deter crime will reflect the public's interest in deterrence.

Bringing economics to bear on criminal sentencing practices is an ambitious and important undertaking. The question that remains to be answered is whether the actual level and structure of penalties contained in the draft guidelines will promote efficient outcomes. Some supporters of the economic approach have expressed concern that the proposed penalties are too large and thus will serve as a costly overdeterrent. Excessive criminal penalties induce innocent firms to invest too many resources in ensuring that they are not falsely accused of having committed a crime; other firms are motivated to overinvest in monitoring the behavior of their agents. Net social losses are the result.

Part of the problem is that the guidelines focus exclusively on criminal penalties, and thus fail to reflect other important penalties imposed on violators. These include extensive civil penalties as well as market sanctions, such as loss of reputation. Environmental offenses, for example, carry federal civil penalties of $25,000 to $40,000 per day. The market also sanctions violators, and these sanctions can be potent—as evidenced by the stock market reaction to safety oversights by airlines involving no criminal activity. (See "The Flight From Equity," *Regulation,* 1987 Number 3/4.) While the guidelines recognize that the economically optimal criminal penalties should take into account these other sanctions, they do not incorporate a practical mechanism for doing so. This biases the guidelines toward excessive criminal penalties.

As can be seen in the table, the guidelines substantially increase criminal penalties (although the relatively small sample size makes it difficult to draw firm conclusions). Considering the average case, the typical firm faces a 7- to 9-fold increase in penalties, up from 0.28 times the damages to 2.0 or 2.5 times. Even for firms that voluntarily turn themselves in prior to investigation (thus qualifying for a multiple of 1.0), the average penalty is more than tripled.

The concern over excessive penalties extends to the commission's antitrust guidelines, which were published in October 1987. The antitrust penalty for horizontal restraints of trade, for example, was increased from three times the damages up to eight times, and allowable damage estimates were increased to 10 percent of gross sales. The guidelines acknowledge that these changes probably will result in nearly a 10-fold increase in typical penalties for antitrust violations. The guidelines also make imprisonment of corporate officers a virtual certainty, when efficiency would generally argue for the use of fines rather than incarceration.

While these increases do not, in and of themselves, demonstrate optimality or nonoptimality, they do raise serious questions about whether the Sentencing Commission has gone too far. In 1985 Congress voted a large increase in criminal penalties that, according to the commission's data, more than tripled the average penalty. Yet the draft guidelines imply an even greater increase over current practice. Some of the policy changes that contribute to larger penalties have a sound basis in theory, including the collection of interest, the assumption of 100 percent restitution, and the elimination of discounts for inability to pay. But the cumulative effect of these and other choices made in the guidelines is an extraordinary change in the stringency of criminal law. A decision to increase penalties by nearly an order of magnitude is a decision to cause a massive increase in the real resources devoted to crime deterrence. Unfortunately the report presents no compelling evidence that such a large increase is warranted.

Another concern is that the guidelines fail to reflect the very different circumstances of detection and conviction for various crimes. With an optimal penalty structure, penalties should vary inversely with the probability of punishment. While there is no good evidence on how these probabilities differ across crimes, say between a violation of an environmental statute and a case of private fraud, certainly these probabilities do differ, probably quite substantially. As indicated in the table, the guidelines

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propose a narrow band of penalties for the typical firm, ranging from no less than 2.0 to no more than 2.5 times social cost. Uniformity in sentencing, the statutory goal of the Sentencing Commission, can only rationally apply to individuals committing a particular type of crime, not to different crime categories.

Finally, there is concern that the guidelines fail to recognize the inherent limits on the courts' ability to calculate accurately the social costs of crime. The range of multiples that the guidelines would apply to social costs (for any particular crime) appears quite narrow compared to current practice, but that does not mean that uncertainty would be reduced. There remains considerable uncertainty in the calculation of social costs. Nor have the guidelines removed uncertainty about the legal standards. Much like present arrangements, firms will not know precisely what the penalty is for any particular crime or where the boundary lies between legal and illegal behavior.

As demonstrated by Richard Craswell and John E. Calfee in "Deterrence and Uncertain Legal Standards," *Journal of Law, Economics, and Organization* (Volume 2, Number 2, Fall 1986), uncertainty alone—whether about the legal standard or its enforcement—can cause overdeterrence even when no multiplier at all is used. When firms know that taking extra precautions can reduce the probability of being penalized, they may take those precautions even when the penalty is simply the calculated net social cost. Inflating the penalty by a multiplier then increases the precautions taken and likely dissuades economically efficient behavior that the legal system does not intend to dissuade.

Apart from the proper structure and level of penalties, the Sentencing Commission is also grappling with the question of probation. The July draft spells out a limited set of cases in which the courts may use probation for monitoring a firm to improve detection of future offenses. Oversight by the courts would generally be limited to ensuring that fines are eventually paid. An alternative proposal, drafted by Professor John C. Coffee Jr., Richard Gruner, and Christopher Stone, and also published in July by the commission, takes quite a different approach: "organizational probation, as a supplementary sentence, makes clear that there is no price that, when paid, entitles the organization to engage in misbehavior." In other words reduce the level of crime to zero, no matter what the social cost. This is diametrically opposed to the logic of optimal penalties.

The Coffee et al. proposal envisions the court acting to correct "inadequate" internal controls in corporations. For a period of up to five years, the court and its appointed probation officers would oversee the running of the firm and would be able to disallow management decisions that they believe might contribute to future violations. Such an approach threatens virtually unlimited intervention by the courts and probation officers into the managerial practices of firms. Nor is it clear how this approach would help. With an optimal set of penalties, firms should have proper incentives to deter crime. It is difficult to believe that probationary supervision would improve the efficiency with which a firm pursues this or any other self-interested objective.

Those who find unthinkable the endorsement of an "optimal" amount of crime (other than zero) are forced to acknowledge that existing sentencing practices do not result in zero crime. Indeed, it is difficult to imagine any sentencing practice that would eliminate crime altogether. This is true for corporations as well as for individuals. Congress passes many statutes that impose strict (if sometimes vague) duties on corporations, with an announced intent to stamp out the reprehensible acts. In practice finite penalties—tempered by prosecutorial and judicial discretion—avoid the inequities and inefficiencies that would accompany a draconian enforcement policy. The mercy of the court is not a particularly helpful guide for corporate behavior, however. In fact, it was the exercise of "unfettered discretion" that gave birth to the Sentencing Commission. The commission's goal, according to a staff working paper, is to develop a determinate, principled law of sentencing.

It will be a significant accomplishment if the U.S. Sentencing Commission succeeds in adopting the economic approach for corporate sentencing. The greatest obstacle seems to be the perception that this approach is too tolerant of corporate crime. In an attempt to allay this criticism, the draft guidelines appear to have incorporated a set of penalties that are too high. That strategy is dangerous, since excessive penalties would impose substantial costs throughout the economy.

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Dying for Drugs

For 50 years it has been illegal to sell drugs that have not been deemed safe by the Food and Drug Administration and for half that time it has been illegal to sell drugs that have not also been deemed effective. Now the AIDS epidemic is causing thousands of desperately ill patients to ask why. Under increasing pressure to make experimental drugs available to patients more quickly, the FDA has taken a series of steps to accelerate the drug testing and approval process. FDA's most recent reform, if it is carried out in good faith and is not reversed in court, could knock up to 4 years off the decade-long process.

Delays in approving promising new drugs have always imposed substantial costs on patients suffering from serious diseases, with little effect on FDA policy. For the first time there is a vocal patient lobby protesting that the drug approval process is producing more consumer injury than protection. Early in August the Presidential Task Force on Regulatory Relief asked the FDA to develop proposals to speed the availability of new drugs for AIDS and other life-threatening conditions that lack adequate alternative therapies. Vice President George Bush asked that the proposals meet three criteria: The FDA should be permitted to consider the risks of the life-threatening conditions that a drug is intended to treat, rather than simply the risks of the drug; American manufacturers should be free to compete with foreign suppliers; and patients and physicians should be afforded broad discretion in choosing among the various risks that confront the patient.

No doubt feeling a heightened sense of urgency when AIDS patients and activists demonstrated outside its offices, on October 21 the FDA published an interim rule announcing a new procedure for clinical testing of drugs intended to treat life-threatening or severely debilitating illnesses. Instead of waiting for the completion of large, costly, and time-consuming "phase III" studies, the FDA said it is now prepared to approve some drugs earlier in the process. Some ambiguity remains to be resolved, however. It is not yet clear whether the agency is willing to base its approval on the data normally available early in testing, or whether it will insist that manufacturers bear the burden of accelerating the collection of data. The FDA's own study of drug testing makes a strong case for earlier approvals, even without any acceleration of data collection.

The FDA study examined the history of 174 drugs that entered human testing between 1976 and 1978. It identified the stages in the clinical testing process that contribute the most toward the likelihood of final approval, thereby providing a crude measure of the value of each stage. Phase III testing, despite its large costs, appears to have the least value.

After typically two years of animal testing, a manufacturer files an Investigational New Drug (IND) application to begin human testing of a chemical entity that shows therapeutic promise. Human testing gives the most accurate information about safety, efficacy, and dosage. It is also slow and costly. Under present procedures, the average drug spends five years in human testing—roughly half of the total drug development and approval time. For reasons that have more to do with the economics of drug development than with regulatory requirements, clinical testing proceeds in three (sometimes overlapping) phases, each involving more subjects and lengthier studies. Only if the initial small-scale results show promise does testing proceed to more elaborate studies.

Phase I studies typically involve 10 to 50 healthy subjects. Designed to assess toxicity and to determine how a drug is metabolized in the human body, these studies generally are completed in a few months. Of the 174 (approved) INDs in FDA's study, 71 percent successfully completed phase I trials.

In phase II clinical studies, a drug is administered for the first time to patients with the condition it is intended to treat. These studies generally are randomized controlled trials involving 50 to 200 subjects and take from several months to two years to complete. These small scale and relatively inexpensive trials are the real crucible of the drug testing process. In the FDA study the number of drugs that completed phase II was less than half of those that started it, and only 32 percent of those that were approved for human testing. Economic concerns were the single most frequent reason for abandoning research during phase II, although safety and efficacy problems were almost as prominent.

If phase II studies are the unkindest cut, phase III trials are a monument to the pursuit of perfection. These trials constitute the most costly and time consuming step in the tortuous journey from test tube to market. Phase III trials typically involve 200 to 1,000 patients, although some

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studies require several thousand. The studies may be completed in as little as one year, but it is not unusual for them to stretch over three or four years. The FDA study found that decisions to abandon research during phase III trials were infrequent, amounting to 14 percent of the products that initiated the trials.

With the completion of phase III trials, New Drug Applications (NDAs) were submitted for 28 percent of the 174 drugs studied; final FDA approval was granted for 20 percent. (In some cases, the study imputed final outcomes for drugs still in the process.)

The significance of phase II studies is striking: more than 90 percent of all decisions to abandon drug development occur before the end of phase II. And the results of phase II studies provide a good indication of the likelihood of final FDA approval. Of the products that complete phase II, 85 percent will also complete phase III, and 63 percent will eventually receive FDA approval. Yet by the time the typical drug completes phase II, it still has not reached the mid-point of the development and approval process. The first two phases raise the probability of success from an initial 20 percent to 63 percent; completion of the remainder of the ordeal raises the probability of eventual FDA approval to only 73 percent.

Based on the results of the FDA study, the phase II clinical trials can be used to predict both safety and efficacy with considerable accuracy. Of course, the phase III large-scale clinical trials do add information. They enable slightly more refined estimates of the risk-benefit trade-offs that are inherent in nearly any drug. Larger samples increase the chances of identifying relatively infrequent side effects and provide an opportunity to test alternative dosages. Much of the information generated in phase III trials ultimately forms the basis for recommendations on the drug's use for incorporation in professional labeling. The critical question about these studies is not whether they are worth conducting, but whether they are worth a one to four year delay in drug availability.

Given the meager productivity of phase III, it seems apparent that such elaborate pre-market testing is counterproductive for drugs intended to treat serious and life-threatening conditions for which there are no adequate alternative therapies. Patients with such conditions simply do not have the time to wait for the results of further testing. Even a cautious patient with AIDS, for example, would presumably be delighted to take a drug that had odds of 2 to 1 for ultimate approval. Indeed, many are taking drugs that are far less likely to receive FDA sanction.

It is difficult to say how much the FDA's new procedures will improve the drug approval process. The interim rule states that for drugs intended to treat life-threatening and severely debilitating illnesses, phase III testing will sometimes be waived. A new requirement has been added, however—the sponsor must consult in advance with FDA staff on the design of phase II studies. This suggests that the FDA will be seeking improvements in the phase II studies: larger sample size, multiple doses, multiple independent investigators, and so forth. It will be a classic bureaucratic response if the FDA prescribes regulation of phase II study design as the cure for problems that result from excessive regulation in the first place. The result may simply be to make phase III studies begin earlier. This is problematic. Because 68 percent of the products that enter human testing are abandoned before initiating phase III trials, resources expended on more elaborate trials in earlier phases may largely be wasted. In most cases, such a change would simply increase the cost of finding out what existing trials can already tell us.

Presumably, drug developers already have the proper incentives to balance the benefits of earlier results against the costs of larger studies. Regulatory attempts to encourage higher cost strategies will reduce the incentives to enter human trials and will inevitably reduce the flow of new drugs. The situation may be even worse since the price of earlier approval also seems to include a requirement for additional "phase IV" studies after a drug is marketed.

The first test of the FDA's intentions will be how it handles the 11 AIDS treatments now in phase III trials. If the FDA is willing and able to approve these and other drugs sooner and with less data, the new procedures will pay off—that is, if the courts let them.

Legislation may be needed to address the real problems in the drug approval process: Simply stated, the law requires excessive certainty that a drug will work before it is allowed on the market. Under the 1962 amendments to the Food, Drug, and Cosmetic Act, a manufacturer must demonstrate efficacy under a "substantial evidence" standard. Substantial evidence is not the relatively weak restraint familiar to all practitioners of administrative law. Rather, the statute defines substantial evidence as "adequate and well-controlled investigations, including clinical inves-

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tigations, by experts . . . , on the basis of which it could fairly and responsibly be concluded by such experts that the drug will have the effect" it claims. This language may leave the FDA little room to approve drugs that are *probably* effective, and little room to consider the needs of patients who have no adequate alternative drugs. Like many other examples of new product regulation, it ignores the possibility that the uncertain new risk may be far less than the known existing risk. For drugs intended to treat serious and life-threatening diseases without adequate alternative therapies, this makes no sense.

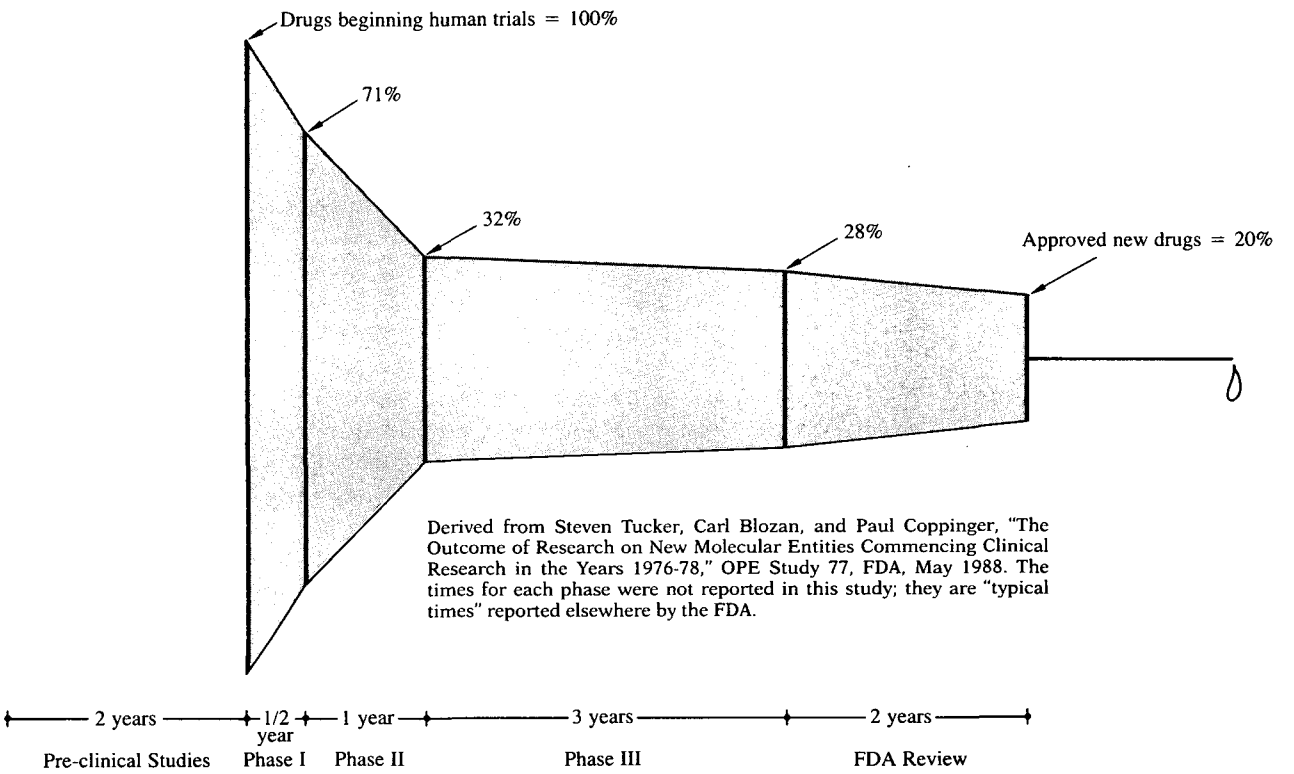
If we want greater certainty that such drugs actually help, the necessary studies can and should be conducted after the drugs are made available to patients—not before. Although the research community will object that such an approach would make it difficult to enlist patients in clinical trials, there is no evidence to support this fear. Indeed, the vast majority of human clinical trials now being conducted involve drugs that are already on the market. These drugs are legally available to anyone who can get a doctor's prescription, yet there is no indication that manufacturers have serious difficulty in enrolling patients in clinical trials.

The drug regulatory apparatus in the United States has developed as a political response to tragedy. In 1937 the drug "Elixir Sulfanilamide" killed more than 100 people in two months; in the aftermath Congress passed the Federal Food, Drug, and Cosmetic Act of 1938 which required manufacturers to prove to the FDA a drug was safe prior to marketing. The Thalidomide tragedy in the 1950s caused a rash of birth defects in Europe and, although Thalidomide had not been approved for use in the United States, provided the political impetus for the 1962 amendments and the "substantial evidence" standard.

The emergence of AIDS as a major public health problem may catalyze a new, and welcome, transformation of the drug approval process. In the face of a growing number of cases of a disease that apparently is always fatal, regulatory delay to dot every "i" and cross every "t" seems increasingly intolerable. Victims of AIDS are the most visible victims of a process that bends over backwards to avoid mistaken approvals of drugs that might not work. Tragic as it is, the AIDS crisis of the 1980s offers a real opportunity for broad reform of the drug approval process.

Eye of the Needle

Drug Approval: Degree of "Filtration" vs. Time Spent in Human Testing



Derived from Steven Tucker, Carl Blozan, and Paul Coppinger, "The Outcome of Research on New Molecular Entities Commencing Clinical Research in the Years 1976-78," OPE Study 77, FDA, May 1988. The times for each phase were not reported in this study; they are "typical times" reported elsewhere by the FDA.

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The Iceberg's Tip

Budget expenditures are a poor measure of the burden regulatory agencies impose on the economy, but have the advantage of being easily observed. In a study published by Washington University's Center for the Study of American Business, "1989 Federal Regulatory Budgets and Staffing: the Effects of the Reagan Presidency," Melinda Warren and Kenneth Chilton report that the performance of the Reagan administration in controlling spending by regulatory agencies has been mixed. As shown in the table below, between fiscal year 1980 and 1989 real spending declined by 10 to 20 percent in half of the 10 largest social regulatory agencies. The largest reduction, 90 percent, was achieved by the Economic Regulatory Administration of the Department of Energy. On the other hand, the Environmental Protection Agency, already the biggest spender in 1980, managed a 70 percent increase during the Reagan administration. As a result, total real expenditures *increased* by 13 percent. EPA now accounts for more than half the total expenditures among these 10 regulatory agencies.

Conventional wisdom has it that economic regulation, unlike social regulation, did indeed wither during Reagan's tenure. This is accurate to a degree: the Civil Aeronautics Board disappeared and the Interstate Commerce Commission cut its real spending by 61 percent. Overall, however, the top 10 economic regulatory agencies grew by 26 percent—twice the growth rate of the social agencies (although in absolute terms, the economic agencies are much smaller than their social brethren). The Patent and Trademark Office, after growing by 89 percent, is now the largest of the group. The Securities and Exchange Commission and the various banking regulators all grew by about 50 percent, while the antitrust agencies shrank by about a third.

Expenditures of the Regulatory Agencies
(Fiscal Years, Millions of 1982 Dollars)

				(Estimated)		% Change
Top 10 Social Regulatory Agencies	1980	1984	1987	1988	1989	1980-1989
Environmental Protection Agency	$1,577	$1,516	$2,249	$2,579	$2,680	70%
Coast Guard	578	494	478	433	465	-20%
Nuclear Regulatory Commission	459	439	347	333	359	-22%
Food Safety Inspection Service	442	348	354	360	358	-19%
Food and Drug Administration	387	369	389	407	380	-2%
Federal Aviation Administration	326	290	294	313	341	5%
Animal and Plant Health Inspection Service	300	327	294	297	267	-11%
Occupational Safety and Health Administration	222	196	194	193	194	-12%
Office of Surface Mining Reclamation and Enforcement	202	352	300	297	207	3%
Economic Regulatory Administration	169	27	20	18	17	-90%
Total	$4,662	$4,358	$4,917	$5,231	$5,269	13%

				(Estimated)		% Change
Top 10 Economic Regulatory Agencies	1980	1984	1987	1988	1989	1980-1989
Comptroller of the Currency	$131	$154	$164	$188	$191	46%
Federal Deposit Insurance Corporation	131	253	277	224	217	66%
Patent and Trademark Office	122	162	208	237	230	89%
Federal Reserve Banks	100	130	145	151	145	45%
Interstate Commerce Commission	90	53	40	36	35	-61%
Federal Communications Commission	88	82	85	85	83	-6%
Securities and Exchange Commission	84	86	94	111	128	53%
Federal Energy Regulatory Commission	79	81	85	84	85	8%
Federal Trade Commission	77	59	56	54	54	-30%
Department of Justice Antitrust Division	57	41	37	37	37	-34%
Total	$958	$1,103	$1,191	$1,207	$1,205	26%

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Regulation After Reagan

Roger G. Noll

RONALD REAGAN'S DEPARTURE from the presidency invites conjecture about whether the policies of his administration will endure. Among the policies most clearly identified with the Reagan administration are those relaxing government regulation of business. Although nearly all recent regulatory reforms had their origins in earlier administrations, many were implemented and had their first visible consequences during the Reagan era. For example, the Reagan administration dismantled the Civil Aeronautics Board (CAB), implemented the near-deregulation of surface freight transportation, and broke up the nation's largest public utility, the American Telephone and Telegraph Company (AT&T), in order to enhance the prospects for competition and deregulation in communications. It also undertook the task of designing workable market processes for interstate transactions in natural gas and electricity, and adopted lotteries rather than comparative fitness investigations to award licenses for new television stations and mobile telephone services.

This article examines whether the regulatory reforms of the Reagan presidency are likely to be retained or even extended in the 1990s or, alternatively, whether regulatory reform reached its apex under Reagan and is likely to be reversed in the next few years. Recent congressional activity suggests that the latter might well be the case. Although the 100th Congress enacted very little legislation pertaining to regulation, numerous bills were introduced to undo previous reforms. Among these were bills that would reregulate the airlines, tighten the regulation of railroads and trucks, and declare a moratorium on further deregulation in telecommunications. In the environmental area legislation was introduced to control acid rain that would require across-the-board retrofitting of the largest sources of air pollution with technological fixes such as scrubbers. Such proposals implicitly reject the use of economic analysis for identifying least-cost solutions to achieving environmental policy objectives, and explicitly reject the use of emissions trading and

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other market mechanisms. These proposals constitute an even more inflexible approach to environmental regulation than that embodied in the Clean Air Act amendments of 1977.

Congressional dissatisfaction with regulatory reform reflects a broader public criticism that has emerged in national media. Airline deregulation has been widely blamed for flight delays and airline crashes, and pundits have observed that divestiture and deregulation in telecommunications have left consumers confused if not abused. The failure to make significant progress in achieving environmental, health, and safety goals is often attributed to the increased reliance of regulatory decision makers on economic analysis and market processes.

Within the spectrum of contemporary American politics the ideological content of microeconomics, and thus the rationale for regulatory reform, is not the cause of controversy.

Critics of regulatory reform offer two reasons why the Reagan policies may not long survive his presidency. One is ideological: the reforms of the Reagan era and before reflected a generally conservative national mood. According to this argument, market processes and economic analysis are intrinsically conservative policy tools. Hence, the life of the regulatory reform movement should coincide roughly with the swing of an ideological pendulum. If the pendulum is returning toward a more progressive ideology, the reforms of the Reagan era are likely to be swept away in its path.

The second reason cited for the likely demise of regulatory reform is consequentialist: regulatory reforms have not delivered their promised benefits, and have made the nation worse off. The reimposition of economic controls in infrastructure industries and the strict regulation of environmental quality, health, and safety will arise because administrative regulation is a superior means of protecting citizens from an array of market failures. Regulatory reform will be swept away because it has been tried and found wanting.

The history of regulatory reform provides ample evidence that both of these explanations are false. One burden of this article is to explain the basis for this assertion. But if the fate of regulatory reform is not tied closely to ideology or performance, it does not necessarily follow that recent reforms are safe from reversal. Instead, it means that the political dissatisfaction with these policies has other causes. The second burden of this article is to identify the roots of dissatisfaction, and to suggest measures that could be taken to preserve the benefits of regulatory reform.

The Ideological Explanation

The intellectual foundation of regulatory reform is microeconomic analysis, which is certainly not free of ideological content. Nonetheless, within the spectrum of contemporary American politics the ideological content of microeconomics, and thus the rationale for regulatory reform, is not the cause of controversy.

The wellspring of modern microeconomics is eighteenth century rationalist liberal philosophy. Its core assumptions are that economic institutions should be evaluated solely on the basis of their effects on the welfare of individuals, and that the best available measure of individual welfare, on average and in the long run, is derived from the choices people actually make. From these simple assumptions economists have derived some arguments that are emphasized by conservative politicians, such as the benefits of competitive markets and freedom of contract, and some other arguments that are emphasized by liberals, such as the theory of market failure and the rationale for corrective measures such as antitrust and environmental policies.

Both proponents and opponents of traditional methods of regulation have used the basic tools of microeconomics to build theoretical cases supporting their positions. That the opponents eventually gained the upper hand may have been largely an accident. The development of computers in the 1950s permitted economists for the first time to engage in serious empirical studies of the economy. While macroeconomists were busy developing the first generation of econometric forecasting models, microeconomists were diligently measuring the efficiency of specific industries. Regulated industries were an obvious early target for study because of the rich vein of data stored in regulatory agencies, most

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of it freely available to the public. Obtaining relevant data about prices, output, and inputs in regulated industries was far easier than coaxing recalcitrant competitors in unregulated businesses to provide the same information.

Economists generally entered the study of regulation with the naive view that regulatory institutions were set up for the purpose of rectifying market failures. Unfortunately, and almost without exception, the early empirical studies—those commencing in the late 1950s and continuing into the 1970s—found that the effects of regulation correlated poorly with the stated goals of regulation. By the early 1970s the overwhelming majority of economists had reached consensus on two points. First, economic regulation did not succeed in protecting consumers against monopolies, and indeed often served to create monopolies out of workably competitive industries or to protect monopolies against new firms seeking to challenge their position. Second, in circumstances where market failures were of enduring importance (such as environmental protection), traditional standard-setting regulation was usually a far less effective remedy than the use of markets and incentives (such as emissions taxes or tradable emissions permits).

The essentially nonideological character of these conclusions is illustrated by two examples. First, in the mid-1960s two quite similar books were published on the origins of the Act to Regulate Interstate Commerce, which established economic regulation of railroads by the federal government. Both books were detailed and extensively researched, and both concluded that railroad regulation was set up essentially for the purpose of forming a more effective railroad cartel. One was written by Marxist historian Gabriel Kolko; the other was written by economist Paul W. MacAvoy, who later served as economic adviser to both President Gerald Ford and Vice President George Bush.

Second, during the late 1960s and 1970s a significant fraction of the new books on regulation were published by either the Brookings Institution or the American Enterprise Institute. The first was noted for its liberalism and its ties to the Democratic Party, while the latter was more known as a conservative think tank with ties to the Republican Party. Yet on regulatory policy issues, it was difficult to tell the institutions apart. Both were busy publishing books and articles by the same set of authors. For example, MacAvoy was the coauthor of a Brookings book on the Federal Power Commission and an AEI series on regulatory policy analysis in the Ford administration. James C. Miller III was the coauthor of a Brookings book on airlines, before joining AEI as a resident scholar and then going on to head the Federal Trade Commission and the Office of Management and Budget during the Reagan administration.

The outpouring of critical research on regulatory policies need not have led automatically to significant changes in public policy. Indeed, on other issues, such as the design of the welfare system, educational institutions, and medical care, economic research seems to have played a less important role in policy development. That research became important in regulatory policy may have been simply a matter of fortuitous timing. The stagflation and other economic difficulties of the 1970s led political leaders to pay greater attention to proposals for improving the performance of the economy, including proposals for regulatory reform. Although the economic logic was tortured, the political logic was straightforward: If the nation suffered from rising prices and low productivity growth, and if regulation caused prices and costs to be higher in regulated industries, regulatory reform was a sensible program for attacking stagflation.

That research became important in regulatory policy may have been simply a matter of fortuitous timing.

The group that jumped on the reform bandwagon was bipartisan. In the case of airline deregulation Senator Edward M. Kennedy convened the first hearings in which a series of academics excoriated the CAB for creating an airline cartel, and Nixon and Ford appointees to the CAB began the process of introducing competition. In the case of telecommunications the key events were the decisions by the Federal Communications Commission in the late 1960s and early 1970s to permit competition in long-distance and customer-equipment markets, and the decision by the Antitrust Division of the U.S. Department of Justice to pursue a restructuring of AT&T. The FCC actions required a coalition between liberal Democrats and conservative Republicans on the commission. The AT&T breakup had its roots in

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the last years of the Johnson administration when, as participants in the Rostow task force on telecommunications policy, Justice Department officials became convinced of the desirability of competition and initiated internal studies of the industry. The case was filed during the Ford presidency; it continued through the Carter administration, and was settled early in the Reagan era. A case grounded only in partisan ideology could not have survived five presidents and even more assistant attorneys general for antitrust.

In environmental, health, and safety regulation the ideological argument must be taken more seriously than in economic regulation. In part this is because there is still a rich intellectual debate about the normative value of economic analysis in this area; hence, the precise boundary of valid uses of economic principles remains controversial. And in part it is because the political debate over the use of economic methods has taken on a more partisan and ideological character. These two factors are not necessarily connected. The scholarly debate about the validity of "commodifying" human life or threatened wilderness is not the source of political controversy. The political debate is about the aggressiveness with which policy goals should be pursued and about the redistribution of wealth that regulation engenders.

My purpose here is not to defend the philosophical foundations of economic policy analysis, so I will not recap the academic debate about commodification, inalienability, and the ethics of the transactions metaphor. Instead I will state my reasons for believing that this debate is largely irrelevant for understanding the core issues in these policy areas.

The import of economic analysis is not in the stringency of regulatory standards; it is in the choice of regulatory strategies for achieving these standards.

First, as many radical analysts have already concluded, the philosophical arguments against the extensive use of economics in environmental regulation apply with equal force to most, if not all, of the economy. For example, Barry Commoner, director of the Center for the Biology of Natural Systems at Queens College, has chastised fellow environmentalists for failing to realize this point and thereby isolating themselves from radical social movements that would eliminate both capitalism and markets. Legal scholar Margaret Jane Radin makes a similar but more detailed argument in analyzing the ethics of markets for prostitution, surrogate parenthood, and adoption. Her conclusion is that, in the absence of transition effects, the complete replacement of markets as a means of allocation is ethically preferable. These conclusions are so obviously at odds with the spectrum of political views held by government officials that it is implausible to argue that this philosophical position motivates their views about regulation.

Second, the use of economic analysis and market mechanisms does not preclude any realistic degree of stringency of regulatory standards. As actually practiced in government policy processes, the core parameters of benefit-cost analysis (such as valuations of life and morbidity and the choice of a discount rate) are determined politically, either by legislation or by officials appointed by the president, rather than derived from economic models using market information. Regulatory standards can be made far weaker, or far stronger, by making relatively minor changes in these parameters. The import of economic analysis is not, therefore, in the stringency of regulatory standards; it is in the choice of regulatory strategies for achieving these standards. Specifically, if emissions standards are under consideration, economic analysis will suggest the least-cost standards. Because the information available to regulators is sure to be incomplete and out of date, however, economic analysis will also suggest that a market-like solution—emissions taxes or tradable emissions permits—is almost always preferable. Hence, the objection to the use of economic analysis in environmental, health, and safety regulation is in reality a rejection of the most efficient methods for achieving policy objectives and of the allocation of burdens implicit in those methods.

Third, even some ardent environmentalists have embraced economic analysis and market-based reforms; this is perhaps the most convincing argument that the controversy is not ideological. In fact, many of the most important contributions to the development of economic methods for environmental policy have been made by economists who are both strong environmentalists and political liberals. More

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significantly, several environmental organizations have come to advocate more, not less, reliance on economic approaches.

The real threat is that the use of economic methods in policy analysis exposes the conflicts that so many political officials face with their constituents. Public opinion polls reveal that, regardless of partisanship, a large majority of citizens favor relatively strong environmental, health, and safety programs, and at the same time oppose government actions that threaten businesses and jobs in their local communities. Politicians can respond to both preferences by stridently advocating tough policy objectives, while pursuing an implementation strategy that rarely forces businesses to close. Economic methods will tolerate, under some circumstances, highly visible pollution, and under other circumstances, highly visible economic dislocation. While economically (and environmentally) efficient, these are politically unpopular outcomes.

In short, the growing dissatisfaction with regulatory reforms based on economic efficiency is not, at base, ideological. Individual political actors have different ideologies and give different reasons for their policy positions, but the ideological differences that are significant in the mainstream of American politics do not explain the debate over the regulatory reforms of the past 20 years.

The real threat is that the use of economic methods in policy analysis exposes the conflicts that so many political officials face with their constituents.

The Performance Explanation

The essence of the performance explanation for the rise and fall in the ardor for regulatory reform is that the policy changes of the past 20 years have not delivered on their promises. A nonideological American pragmatist might conclude from the information available in 1970 that regulation led to inefficiency and that regulatory reform held significant promise, but then conclude in the late 1980s that the cure had been worse than the disease. Based on experience, imperfect government might well do better than imperfect markets.

Other articles in this issue deal with the actual effects of regulatory reform in some important cases, so I will not go into detail here. Instead I will offer some key generalizations that reflect the consensus of the research literature on the effects of recent regulatory reforms.

- Economic deregulation reduced prices and costs in literally every industry in which it was tried. Prices fell because competition replaced monopoly and, more importantly, because deregulation caused efficient firms to grow at the expense of inefficient ones, and led some inefficient firms to improve.

- Economic deregulation did not cause every price to fall, because under regulation some prices purposely had been set below costs—with losses offset by higher prices elsewhere. Price increases are more likely to occur in rural areas and small towns, which historically had been favored in regulatory price setting.

- In only a few cases did a truly competitive market replace regulation. AT&T probably still retains market power in some long-distance markets and in some lines of telecommunications equipment, and the hub-and-spoke structure of the airline industry probably gives some airlines market power in their major hubs. In most cases, however, if the extent of competition is less than perfect, the reason is generally that policy interventions are not permitting as much competition as would emerge naturally. Remaining federal and, especially, state regulation limits competition, and other federal policies (such as those governing airport construction, the awarding of landing and take-off slots, and merger approvals in the airline industry) have not accommodated healthy competition.

- In no case was overall industry safety or service quality adversely affected by economic deregulation. Nonetheless, some specific problems did emerge. In some cases the transition to less regulation caused intermittent reductions in service quality for some customers; in other cases the quality effect was ambiguous. For example, the replacement of less frequent jet service by more frequent commuter-aircraft service changed the nature of the product for some consumers in

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small cities, probably leaving some better off and others worse off, depending on their valuations of flight frequency in relation to comfort and the additional safety of larger airlines and aircraft.

- A substantial portion of the reductions in prices and costs following deregulation was due to the weakening of labor unions and the lowering of wages. Total employment in the former Bell System was cut, especially by the divested AT&T, in order to improve the system's competitive position in telecommunications. In transportation the power of unions was vastly undercut by the removal of entry barriers and the emergence of discount carriers, many of which are nonunion. Overall, however, deregulation increased employment by lowering prices and raising sales volume. More people are being employed at generally lower wages.

- In the environmental, health, and safety arena, especially during the 1980s, there has been little if any improvement in measures of environmental quality and illness and injuries related to products and workplaces. With very few exceptions, performance measures have changed only a few percent, one way or the other, over the past decade. The optimistic interpretation is that regulation arrested a deterioration in these measures. Advocates of these programs clearly sought more than this, however, and they express growing dissatisfaction with the progress that has been made.

- Environmental, health, and safety regulation has imposed substantial costs on a few key industries, such as chemicals, electric utilities, steel, and automobiles. These costs do not, however, loom large with respect to the performance of the national economy as evaluated with core macroeconomic indexes, such as productivity, balance of trade, employment, or inflation.

- From the vantage of economic analysis, regulatory effort in the environmental, health, and safety arena appears to be badly misallocated. Some pollutants and hazards are far more intensely regulated than others that are more serious. And some industries are regulated far more intensely than others that produce exactly the same pollutants. As a result, society could have spent far less to achieve the amount of progress that has been made or, alternatively, could have made far more progress at the costs that have been incurred.

The key issue is the extent to which economic approaches to regulatory reform are responsible for the successes and the failures of the Reagan era. Obviously the answer is very different in the case of economic regulation than in the case of social regulation.

With respect to economic regulation, increased competition had predictable effects, including the adverse effects on unions and the rising relative prices facing rural consumers. Also predictable was the dependence of the performance of deregulation on the response of other government policies such as antitrust, infrastructure construction, and state regulation. Neither category of consequences can be considered a failure of economic deregulation; indeed, the overall effects of economic deregulation should lead advocates of unionized labor and rural constituencies to realize that regulation was a weak, inefficient means to obtain their objectives. The magnitude of the economic benefits to these groups was small compared to the efficiency gains from deregulation.

For other forms of regulation the principal lesson is that when economic reforms are highly limited, so are the resulting benefits. The Reagan administration adopted two policy reforms advocated by economists: institutionalizing economic analysis in the regulatory process, and permitting a very limited use of emissions taxes and trading as an adjunct to traditional environmental standards. Economic analysis has made some small headway in undermining a handful of excessively stringent standards. Judging from the array of standards across industries and sources of hazard, much less headway has been made in affecting regulatory priorities and in rationalizing the distribution of the costs of achieving regulatory objectives. The absence of significant progress, or the presence of substantial costs, is hardly a consequence of the application of economic approaches.

The principal lesson is that when economic reforms are highly limited, so are the resulting benefits.

Although performance shortcomings take a different form in economic and social regulation, the ultimate conclusions are the same. First,

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experimentation with economic approaches has provided convincing evidence that regulation is an exceedingly expensive way to protect jobs, companies, and specific communities. Second, economic policy reforms have not led to the maximum possible increase in efficiency primarily because they have been applied in too limited a form. Some anticompetitive regulation persists in nearly all cases; procompetitive actions to facilitate economic deregulation have not been pursued with full vigor; and economic approaches to social regulation are but a small tail on the very large dog of traditional standard setting.

The Real Explanation: Politics as Usual

Two decades ago scholars of regulation were skeptical of the prospects for regulatory reform. The infirmities of regulatory policy making seemed to be deeply ingrained in the American political system, which led both liberal and conservative government officials to be excessively responsive to the demands of well-organized, homogeneous pressure groups. Regulatory agencies were used to protect and to enhance the economic positions of politically influential industries. Economic approaches to regulatory reform were regarded skeptically because of the threat they posed to established economic interests. Initially even the most ardent advocates of effective regulation, such as consumerists and environmentalists, sought primarily to be given a seat at the bargaining table so that they, too, could be cut in on the distribution of benefits from administrative processes.

Despite these obstacles extensive economic deregulation has taken place and there has been a noteworthy expansion of economic approaches to social regulation. With the single exception of the CAB, however, all of the regulatory institutions in existence in 1970 still exist today. The same economic interests still participate in the administrative processes of regulatory agencies and still lobby the members of Congress who sit on the relevant oversight committees. Even the airlines have the U.S. Department of Transportation, the House Energy and Commerce Committee, and the Senate Commerce, Science and Transportation Committee, all of which still play important roles in shaping the industry. Consequently, all of the political forces that gave rise to regulation are still in place, leaving industries, unions, and favored communities the same forum for pleading their cases. The real test of regulatory reform now and in the years ahead is whether these interests will be able to undo what has been done thus far.

Opponents of regulatory reform ought to be weaker now than they were a decade or two ago. For one thing, the entrenched economic interests that unanimously favored the use of regulation to protect themselves are more divided. The firms and employees that have fared best under regulatory reform are stronger, and protected firms and unions are weaker. In no major industry can a consensus be formed in favor of reversing the policy changes of the past decade. In addition, to the extent that the force of argument and evidence matters in policy debates, the case for regulatory reform is stronger. Numerous dire predictions—airline, truck, and rail accidents, loss of service to smaller cities, rampant increases in pollution—have not come to pass, whereas the economic benefits of lower costs and prices did take place as predicted.

Of course, the incomplete nature of each major example of regulatory reform poses real questions about the durability of reform. Obviously political officials have been only partially committed to reform. Perhaps this is because of political risk aversion: by undertaking partial and gradual reform, political officials could monitor progress and quickly reverse course if performance deteriorated. Since performance in fact has improved, we should expect politicians to be willing to try further reforms in the future. These might include elimination of the ICC, further movement toward deregulation of telecommunications, and expansion of the bubble and offset concepts in air pollution control in the direction of a market for emissions permits.

To the extent that the force of argument and evidence matters in policy debates, the case for regulatory reform is stronger.

Unfortunately the history of regulatory reform of the 1980s does not appear to fit this view. Little has been accomplished during the second term of the Reagan administration, undercutting the argument that past success should breed further reform. So perhaps the explanation is that

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regulatory reform was a happenstance, made possible by a decade of unusually poor performance by the American economy. As the economy recovered in the 1980s, the underpinning for regulatory reform disappeared, and "business as usual" in regulation, with its susceptibility to special-interest politics, gradually returned.

Fortunately a more optimistic view is also consistent with the facts. It is that regulatory reform ran out of steam in the Reagan administration for reasons peculiar to the policy agenda of the president and his key advisers. For example, right from the beginning the Reagan administration held a commitment to a version of federalism that has not held sway in the White House since the nineteenth century. In essence it sought to devolve to state and local government as much policy authority as possible—even if that meant stepping aside to let state and local regulatory officials substitute highly inefficient forms of traditional regulation for federal regulatory reforms.

In addition the Reagan administration has appeared to be more oriented toward eliminating government constraints on businesses than toward promoting efficiency. The early Reagan appointees at many regulatory agencies sought not to introduce efficiency criteria for setting priorities and changing regulations, but simply to relieve industry of what it regarded as the most expensive requirements. Numerous aspects of a durable reform were simply overlooked, such as a complementary antitrust policy and the use of market-based incentives in social regulation. The result was that regulatory reform produced less economic benefit than was possible, and lost momentum once some of the most odious regulatory policies were reversed.

Finally, the Reagan administration has had a relatively poor relationship with Congress, especially since the 1982 congressional elections. Historically, effective regulatory reform has been achieved through cooperative ventures between the president and Congress and has depended on alliances across party lines. Even the Carter administration, also regarded as less than adept in its relations with Congress, worked closely with the legislature in getting regulation relaxed in transportation and energy. But for the most part the Reagan administration has not consulted with Congress about regulatory reform and, in some cases, such as the FCC's actions in telecommunications and broadcasting, has been openly confrontational. It is noteworthy that the most important economic policy reform of Reagan's second term—the tax bill of 1986—was the outcome of a process in which both the executive and legislative branches played major roles, and in which leaders of both parties were in a position to claim some of the credit. In regulatory policy there were no parallel attempts at serious collaboration and compromise.

If these observations explain the snail's pace of reform during Reagan's second term, new faces in Washington ought to be in a position to resume progress. The fundamental arguments in favor of further economic deregulation and economic approaches to more efficient social regulation are stronger now than a decade ago, for intervening events have provided confirmation of their value. Moreover, the political case for regulatory reform does not appear to be much weaker than before. Indeed, past reforms have created new interests that have a stake in the improved performance that resulted; these can be mobilized against the interests favoring the use of regulation to protect themselves. But further success will require that the next administration adopt a holistic approach to regulatory reform: actively pursuing policies to ease the transition to a less regulated economy, working with a bipartisan congressional coalition for regulatory reform, and taking effective actions to make certain that inefficient federal policies are not simply replaced by equally undesirable state regulations. All of this will require that the new administration adopt a coherent, broadly consistent approach to regulation, regarding it as something more than a group of discrete and unrelated specific problems to be solved by writing a better regulation. □

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Mandated Benefits — On the Agenda

Marvin H. Kosters

INCOME SECURITY provided by the government may not extend from the cradle to the grave, but calls for the government to apportion more resources to specific uses along the way have become commonplace. Child care for working people, health plan coverage linked to jobs, long-term care for the elderly, and family leave for workers to care for newborns, ailing children, or parents are among the initiatives now on the horizon. With the federal budget deficit already embarrassingly large and the public apparently unwilling to accept higher taxes, proposals for mandated benefits would have the government supply the mandate, while generally shifting to employers—and ultimately to workers and consumers—the responsibility to finance those benefits.

The push to enact new benefit programs has been emanating from Congress and represents a real departure from the policies pursued during the Reagan administration. Regulatory relief, for example, was a major element of the Reagan economic program. The goal was to reduce the costs imposed on business and increase reliance on private markets. Tax relief was a second major element of the Reagan economic program—leaving more income in the hands of those who earned it. And a third element was reducing the growth of federal spending, often by targeting spending more closely on those with low incomes. Legislative proposals to mandate new benefits would reverse, at least partially, each of these policy initiatives.

The proximate reason for the spate of new congressional initiatives was the shift to a Democratic majority in the Senate after the 1986 elections. Among other significant changes, the chair of the Labor and Human Resources Committee passed from Senator Orrin G. Hatch to Senator Edward M. Kennedy. In addition the federal budget deficit, and pressures to contain or reduce it, have left little scope for major new direct spending programs. Mandated benefit programs have opened a new avenue for responding to constituencies seeking to advance their interests through governmental policy. Constituent services can be expanded without explicitly raising spending or taxes to pay for them.

Federal benefit mandates that have already been enacted include requirements for continued health plan coverage of former workers and their family members, and advance notice (or severance pay) requirements for major layoffs and plant closings. Proposals for increasing the minimum wage and for guaranteeing reemployment for workers taking family leave failed because filibuster threats could not be overcome. These

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proposals, and others such as health plan requirements, are almost certain to be on the agenda of the next Congress.

While politically appealing, mandated benefit programs raise some important economic issues. For example, are the benefits worth the cost either for the individual worker or for society as a whole? How are individual choices affected? Who ends up paying the costs? And how seriously is job creation discouraged by mandated benefits that raise employment costs? This latter question is crucial to relatively low-wage workers for whom the increase in employment costs would loom large—the group the proposals are ostensibly designed to benefit.

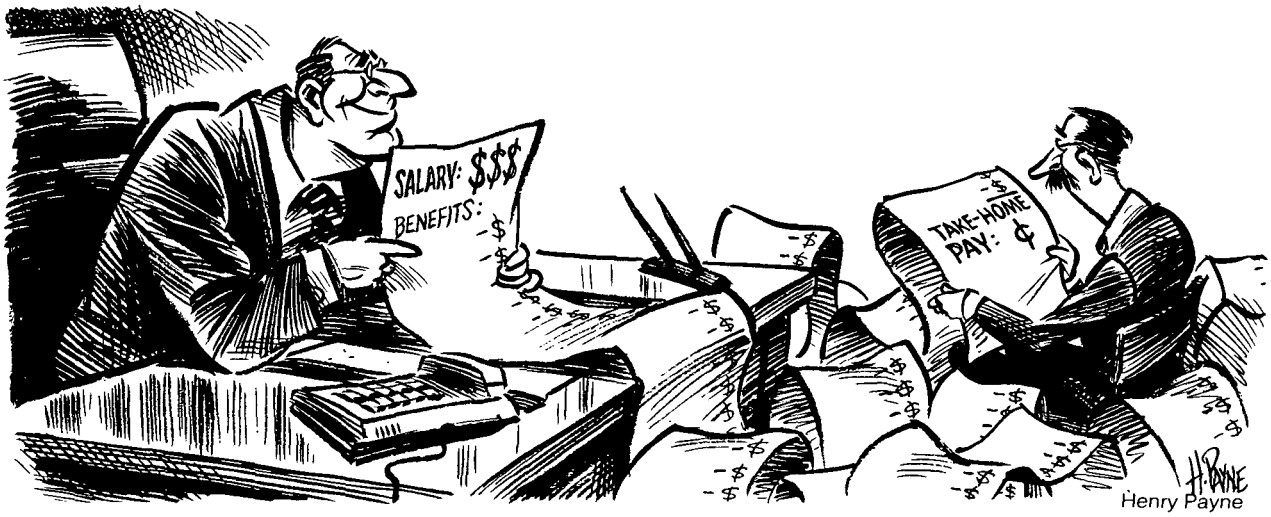
Mandated Benefits and Mandated Costs

The many diverse proposals for mandated benefits have in common a promise of some particular benefit to workers: improved wages, job security, pension plans, leave policies, health care, and so forth. Of course, if only benefits were involved, there would be no need for a mandate. Each mandated benefit implies a mandated cost, however. We can distinguish among the various proposals by looking at the mechanisms used to finance the costs and the opportunities these mechanisms provide for shifting the incidence of the costs.

Some of the oldest government-mandated programs are financed by an explicit tax on labor. Social Security, the best known and by far the largest program, is financed by taxes levied directly on employers and employees. Others, such as unemployment insurance, workers' compensation, and pension fund insurance, are financed by taxes levied on employers. In each case the actual incidence of the tax is likely to rest primarily on workers because the total cost of hiring additional workers includes the taxes paid to finance their benefits. For these programs collecting tax revenues and dispensing benefits are both administered by a government agency.

More recent proposals would mandate benefits that are financed and administered privately. For example, parental-leave proposals create a benefit to which workers are entitled and regulations that define exactly what that entitlement is. Financing and administering the program would be the obligation of the employer. For certain other benefits, such as health-care coverage, the government contributes indirectly to the financing by exempting the costs from the income tax—at least that portion paid by the employer. The primary obligation to provide the benefit, however, remains the employer's.

A law may appear benign when it simply requires benefits that in many cases would have been provided voluntarily. But government-mandated programs often displace voluntary arrangements that might have been part of private employment contracts. When the government mandates benefits in instances where the parties would not have agreed to them voluntarily, some parties are bearing an unwanted burden and will attempt to avoid it. The analysis of how these burdens affect private behavior, and how private behavior in turn shifts the incidence of the burdens, is in essence an analysis of tax incidence—regardless of whether the tax is explicit or implicit. Benefits that are mandated as a condi-



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tion of employment can be regarded as a tax on employment, even if no government agency directly collects the tax and dispenses the benefits. Analysis of the incidence and indirect effects of such a tax is less straightforward, however, than in the case of a payroll tax that is withheld for all workers.

A key difference between government-financed and employer-financed benefit programs is that government financing may effectively guarantee the benefits with the full faith and credit of the United States. One consequence is that, from the point of view of both employers and employees, benefits and costs may appear only loosely coupled. The cost experienced by firms is determined by the level of taxes the government imposes. Individuals' benefits are determined by the benefit and eligibility regulations. There is no assurance that the government will link these factors for an individual or a firm, or that it will set these factors to keep its fund in balance. Unfunded liabilities may therefore be shifted to other workers, to taxpayers in general, or to taxpayers in future generations.

In employer-financed programs benefits and costs are more closely linked. Even in the case of benefits that are due far in the future (such as health care for retirees), liability for the associated costs will be recognized immediately and will affect the performance of markets for goods, capital, and especially labor. Cost-shifting will generally be limited to a firm's customers, stockholders, bondholders, and labor force.

A third type of financing deserves mention here: a direct tax credit to qualifying individuals. While not strictly a mandated benefit (since there is no mandate), this type of financing can be a policy alternative to financing through employers or through a dedicated government tax, as well as to direct government spending. Under one proposal, child-care benefits would be supported mainly by federal spending out of general revenues. A sizable component of the funds would initially be devoted to developing regulatory standards for providers and procedures to administer spending on child-care assistance. Under another proposal, the dependent child-care tax credit would be made refundable to low-income families, and a new children's tax credit would be introduced for low-income families with children, whether or not the parents choose to work. If a child-care program were enacted, however, it might well include some employer mandates. This article will focus mainly on employer-financed programs, keeping in mind the alternatives of government financing through special funds, general revenues, or tax expenditures.

Resource Usage

Proposals to mandate benefits are usually discussed piecemeal in the context of the needs of particular segments of the populace, the quality and availability of particular services, and the affordability of services for those who need them. For the citizenry as a whole, however, devoting more resources to any one use means devoting fewer resources to other uses. That is, enhancing the quality and amount of any particular service entails assigning higher priority, and devoting a larger share of the national output, to that use at the expense of other uses, including spending and investment choices that would otherwise be made by consumers. Benefit mandates cannot, in and of themselves, increase the national output.

Mandating additional benefits would raise still further the share of total compensation devoted to benefits, further reducing the share available for workers to spend at their own discretion.

The cost of benefit programs already in place accounts for a very significant and growing share of employees' total compensation. In 1987 employer-paid costs for health and retirement plans, and social security tax payments by employers and employees, accounted for 23 percent of total compensation, up from 17.5 percent in 1973. In addition workers must often pay a share of the costs of health and retirement plans. Many workers also contribute to flexible spending accounts that enable them to pay health and child-care costs with pre-tax dollars. Mandating additional benefits would raise still further the share of total compensation devoted to benefits, further reducing the share available for workers to spend at their own discretion.

The fact that something must be given up to get more of something else is illustrated by recent trends in employee compensation. During the past 15 years, output and total real compensation

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per hour of work have increased by about 9 percent. The cost of supplements paid by employers, however, has increased much more rapidly, raising the employer-payments share of compensation from 12.8 percent to 16.4 percent. As a consequence the wage and salary component of real hourly compensation has been quite stagnant. Employer-paid benefits have absorbed most of the small increase in output per hour of work since the early 1970s, leaving virtually no room for an increase in wage and salary income. Devoting a still larger share of the national output to mandated benefits would widen the gap between increases in real output per hour of work and in the wage and salary portion of employee compensation.

Taxing by Regulatory Mandates

Use of law and regulation to produce public benefits as an alternative to direct, tax-financed spending is quite common. Perhaps the best known and quantitatively most important example is pollution abatement regulation. Environmental regulations require firms to pay for equipment to reduce pollution, with the increase in costs passed on to consumers. Workplace safety and health regulations are yet another example of a program financed through requirements placed on businesses.

The intended beneficiaries of these programs have traditionally been broadly defined. Pollution abatement, for example, is intended to benefit the general public. Social insurance and workplace safety and health programs are intended to benefit the entire work force. These programs have traditionally provided benefits that "everyone" might be presumed to want.

In contrast the new mandated benefit proposals, which would also amount to new regulatory programs, are generally intended to provide benefits to much narrower constituencies. Family-leave and child-care programs are cases in point. Moreover, benefits that some may not want—either at all or in the form provided by government—would be mandated. And qualification for benefits would be conditional on decisions about work and family life that have hitherto been viewed as matters best left to private choices by workers and their families or by workers and their employers. Accordingly, some of the proposed mandated benefit programs are much more intrusive with respect to personal and family choices than most traditional programs. They also place important economic benefits outside the realm of bargaining and other informal arrangements for setting pay.

Labor Market Effects

The targeted nature of mandated benefit proposals is part of their political appeal: politicians appear to be making promises to particular constituents at corporate expense. This is easy to do rhetorically but difficult to do in fact. Wealth redistribution cannot be effected through the intermediation of employers nearly as easily as it can through the U.S. Treasury. While a corporation may be obligated by law to finance certain benefits, it must turn to markets to obtain financing, and transactions in those markets remain largely voluntary. Real costs fall on real persons: stockholders, bondholders, consumers, and employees.

To the extent that mandated benefits are contingent on employment and other identifiable factors, so are the associated costs. For instance, workers in a cyclical industry benefit disproportionately from layoff notification requirements. From the company's point of view, the potential cost of notification looms largest in those same industries. For this reason the law inhibits job formation in exactly those industries where it was supposed to enhance job security.

We can expect this pattern to be quite general. Benefits that are contingent on employment will—like any tax on labor—be paid for largely by employees. Parental-leave benefits will handicap prospective parents in the labor market; generous health benefits will handicap those prone to illness; benefits of value only to women will reduce the wages women can command.

These tendencies should not be attributed to perversity on the part of corporate managements. Firms that are exposed to large labor costs will, in the absence of other adjustments, necessarily experience higher prices and/or lower rates of return. Regardless of what management thinks or does, anonymous consumer markets and capital markets will direct the burden of costs to those factors upon which they are contingent.

One likely political response to these effects is a proliferation of rules against "discrimination." Of course, it is the government that attempted to provide benefits to one favored group at the

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expense of others. Markets simply react to that. Young women, old men, large families, part-time workers—whoever is given an entitlement—will feel its burden as well. The difficulties that firms may encounter in administering mandated benefit programs can be illustrated by the requirement under the 1986 tax reform act that they demonstrate equitable distribution on the basis of the value of benefits workers actually choose instead of equality of access.

The effects of the implicit taxes on employment imposed through mandated benefit requirements can be expected to differ markedly among workers at different levels of earnings. Benefits that are mandated for all workers restrict individuals' ability to choose or to negotiate the combination of wages and benefits they prefer. Some might be forced to subsidize benefits for which other workers would be the main beneficiaries, while others might themselves be subsidized by their co-workers. While individual workers with relatively high earnings might prefer a different mix of wages and specific benefits, however, there would be ample scope for substitution between wages and benefits for high-wage workers as a whole. The mandated benefits are likely to be well within the range of what a high-wage worker would choose to purchase anyway. This is not so for low-wage workers.

Impact on Low-Wage Workers

For workers with low earnings, benefit mandates would have a severe impact on the portion of total compensation paid out in wages and salaries, and would likely result in a very different pattern of compensation than they would choose voluntarily. The problem is most severe for workers at the very low end of the earnings scale for whom the value of what they can produce is lower than the combined total of mandated benefits and wages in their compensation package. Squeezed between mandated benefits and the minimum wage, these workers would likely find their jobs in jeopardy. For workers who are able to retain their jobs or obtain new jobs, mandated benefits limit the flexibility of workers and employers to structure mutually beneficial arrangements, inducing employers to invest less in employee training, for example, than workers would prefer.

The problem of mandated benefits for the lowest-wage workers is illustrated by proposals for mandatory health plan coverage. Among workers with no health insurance coverage, more than half are working at hourly wages below 125 percent of the federal minimum wage. One proposal of the 100th Congress would have raised the federal minimum wage by about 35 percent. Mandatory health plan coverage could raise the effective minimum legal level of compensation for full-time workers by an additional 25 percent, for a total increase in hourly compensation of about 60 percent.

Exempting part-time workers, for whom compensation costs would be increased disproportionately, or exempting small firms, would help to mitigate the adverse effects of mandated health plan coverage on employment. But such exemptions would also leave more people without health plans. According to estimates reported by Dr. Deborah Chollet, senior associate at the Employee Benefit Research Institute, even if all those working at least 18 hours per week and their dependents were covered by mandatory health plans—and no job losses resulted from setting such a high hurdle for compensation—only about two-thirds of the uninsured would be added to the rolls. Thus benefit mandates are an extremely inefficient way of transferring benefits to people who lack them, just as minimum wage requirements are an extremely inefficient way of raising the incomes of those at the low end of the pay scale.

Squeezed between mandated benefits and the minimum wage, these workers would likely find their jobs in jeopardy.

Needs and Affordability

Those making a case for mandated benefit programs typically develop estimates of the numbers of people affected. The dimensions of the problem are documented in reports showing, for example, that more than half of mothers with small children are working, millions of people are not covered by health plans, and growing millions of the elderly will need nursing-home care or other assistance. Data on demographic characteristics, income levels, and costs are widely publicized. Strong growth trends, both for numbers

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affected and for cost of services, help to convert problems of setting priorities and making choices into national crises. Judgments are usually made by experts that the people who need services are increasingly unable to afford them and, consequently, that the government needs to step in.

The question of affordability is frequently confused by the failure to distinguish clearly between regular and predictable needs and those that arise unexpectedly and rarely but are very costly. Needs that arise in these latter circumstances might only be affordable through insurance arrangements. But regular and predictable needs that are not affordable by particular groups can only be made available by providing income transfers. To illustrate this distinction consider regular payments for mortgage interest, maintenance, utilities, and taxes on a house, as differentiated from the loss that arises from complete destruction of the house by fire. Most people who own a home can afford the regular and predictable costs of home ownership, but cannot absorb such a major loss. They can, however, afford insurance that covers severe losses when the probability of occurrence is small and reasonably predictable. Thus, although most of the elderly cannot afford the cost of serious illness or prolonged nursing care, most of them can, as members of a group, afford insurance to cover such contingencies.

Some proposals for mandated benefits involve elements of insurance against risks, but many are intended to cover either regular and predictable expenses or contingent needs that may not warrant insurance coverage. Child-care benefits, for example, cover regular and predictable costs. In addition, of course, the need for such services is itself contingent on family decisions about childbearing and work. Other kinds of mandated benefits, such as family-leave programs, have apparently not been regarded as warranting insurance coverage by most members of the work force, judging by the fact that they have rarely been included in collective bargaining agreements or other voluntary arrangements between employers and workers.

Affordability of benefits can be improved in only two ways. One way is by developing insurance arrangements to spread risks. For most risks worth covering, insurance is available—or likely to become available—from private commercial providers. For risks that are beset by serious problems of adverse selection or moral hazard that cannot be handled through contract design, government policies might be helpful. In many instances, however, government policies tend to undermine the affordability and availability of insurance by setting minimum standards that preclude low-cost coverage. Requirements enacted by states, for example, regulating who qualifies for reimbursement under health insurance programs suggest that standards more often reflect the interests of provider groups, such as psychologists and chiropractors, than of health insurance consumers.

The second way affordability can be improved—at least for some people—is by shifting the cost of particular risks or by instituting other mechanisms for making transfers. This is frequently one of the effects of a policy and, even more frequently, a major goal of its proponents. Child-care and parental-leave requirements for employers, for example, are likely to impose costs on a much broader group than the direct beneficiaries. It is not at all clear, however, that the net effect of general benefit mandates would be to improve the economic circumstances of workers in low-income families, partly because of the depressing effect on wages and partly because the benefits would often be produced at higher costs than under informal private arrangements.

The need to improve affordability for the poor is often the most persuasive argument used to make the case for imposing benefit requirements on employers. Yet the programs that are developed usually do not limit benefits to the poor. Either the requirements are made applicable to most of the work force or the benefits are phased out only after extending well into the middle class. As a consequence, these programs are very costly, and it becomes essential to scale back their costs. Ironically, the likely result is inadequate benefits for those whose low incomes and benefit needs played a major role in making the case for benefit mandates in the first place.

Quality and Cost Escalation

When policy discussions turn to mandatory benefits like health insurance, where coverage must meet certain minimum standards, the "minimum" is typically defined in relation to current plans. Any distortions in present arrangements are thus carried over to mandated programs. Although employers have tried to intro-

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duce incentives to discourage excessive usage, the health plans they provide still reflect the fact that their costs are paid in pre-tax dollars. These tax advantages lead workers to prefer relatively low deductible amounts and relatively little cost-sharing. In other words, workers choose health benefit plans that are strongly oriented toward reimbursement for regular and predictable expenses (which would otherwise have to be paid in after-tax dollars), rather than for extremely serious and costly health problems that are experienced only very infrequently. Thus the health benefits provided by most employers are more appropriately characterized as health plans than as health insurance.

Tax incentives have another effect on health plans: they produce a form of quality escalation of plan characteristics. Standards based on these plans would impose this (tax-induced) level of quality on everyone, including low-income employees for whom the tax consequences may be far less important. Many of the beneficiaries of such mandated plans might be better off with plans designed primarily to provide insurance against serious risks.

The cost of services provided in response to government mandates is also likely to be higher at each quality level. Mandated benefit programs inevitably bring with them government regulation to specify in detail what is provided. Qualified providers are usually defined in terms of characteristics of facilities, credentials of care givers, and formal licensing of both. Informal arrangements and arrangements within extended families are frequently unable to meet regulatory standards, even when their quality is equivalent or superior to that of institutional providers. Standard setting also tends to limit diversity and to reflect the preferences of care givers instead of clients. Regulatory standards that define "qualified" plans can thus be expected to produce cost and quality escalation.

Conclusions

Federal policy initiatives have increasingly turned to mandated benefits linked to employment to influence uses of the national output. Because the benefits are financed by employers, and eventually paid by consumers, shareholders, and workers themselves, their costs are not reflected in federal spending and the budget. Costs are obscured and often borne by a broader group than the beneficiaries.

The primary effect of requiring that more output—and a greater share of employee compensation—be devoted to particular benefits is that less is available for other uses. From the standpoint of employees, this reduces their discretion to choose the mix of benefits and wages that best satisfies their diverse needs and preferences. It also discourages job creation. Mandated benefits tied to employment, which are equivalent to a tax on employment, reduce job opportunities, particularly among those with the poorest earnings prospects who can least afford the benefits proposed.

Direct government spending is preferable to benefit mandates and the regulation that comes with them.

To increase the amount and quality of particular benefits to low-income people—whether day care, health care, or pension benefits—government policy should attempt to provide additional income support directly. This would best accommodate the preferences of intended beneficiaries. If the problem for low-income people is seen primarily as one of too little spending for particular uses instead of too little income, tax credits or in-kind subsidies (such as food stamps or rent vouchers) should be considered. Such an approach would leave room for choice while helping to control costs. Introducing new federal spending or tax benefit programs when the federal budget is deeply in deficit is undoubtedly awkward politically. Raising taxes to pay for these programs could also fuel concerns that bigger government, not smaller deficits, would result. Nevertheless, direct government spending is preferable to benefit mandates and the regulation that comes with them.

Benefit mandates restrict the scope for individual choices to reflect differences in circumstances. In particular, they limit opportunities to exercise one of the most basic choices: taking a job, gaining work experience, and thereby adding to the national output—instead of further subdividing its uses. Despite their understandable political appeal, mandated benefit programs are little more than costly efforts to escape the dilemma posed by setting priorities on the uses of our national output. □

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Telecommunications Policy in the Reagan Era

Robert W. Crandall

WHILE OVERALL the outgoing administration can find relatively little to boast about in regulatory policy, there is one bright spot in the Reagan record: the progress made in liberating telecommunications from the heavy hand of government. The AT&T antitrust case was settled by a court decree that broke up the company and thereby facilitated a substantial increase in competition in both telecommunications equipment and telephone services. Regulatory shackles on broadcasters were loosened. Legislation was passed that further weakened government control over cable television. And the Fairness Doctrine was set aside—at least temporarily. These were no mean feats given the considerable political opposition to reform.

This article reviews the remarkable changes in telecommunications regulation during the eight years of the Reagan administration. While the focus is on the unfolding saga of the telephone industry, I also provide a brief review of the more important developments affecting broadcasting and cable television.

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The End of the Bell System

Twenty-five years ago, few would have believed that the government would break up AT&T to promote competition in telephone services or equipment. Indeed, few would have believed that such competition was desirable or even feasible. It was, and is, a widely held belief that the telephone industry is a "natural monopoly"—a belief actively promoted by most national post office, telephone, and telegraph authorities who still cling to the notion that any private offering of telephone service is essentially antisocial.

The Evolution to Competition. In the United States (though not in most other developed countries) the telephone monopoly has all but disappeared. AT&T's share of the long-distance market now stands at less than 70 percent. Competitive vendors of telephone equipment have eroded what was once a virtual AT&T monopoly. Even local telephone companies are facing limited competition from cellular systems, fiber optics, and shared tenant systems.

Competition in both long-distance services and equipment was ushered in when the Federal

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Communications Commission (FCC), in the late 1960s, permitted MCI to enter interstate long-distance service. At first the FCC thought that it was permitting competition only for private-line services used by medium to large businesses. By 1977, however, it was clear that the commission had lost control of its limited-entry policy and was unable to keep MCI from offering ordinary (switched) long-distance service.

Proceeding more deliberately, the FCC also moved to liberalize entry into the offering of terminal equipment used on the national telephone network. In the late 1970s, after several years of battling with AT&T over the dangers that competitive equipment might pose to the integrity of the network, the FCC finally prevailed by requiring that any manufacturer's appropriately certified terminal equipment be permitted to connect to the network. Federal courts repulsed state challenges to the commission's preemption of state authority in this matter.

By 1981 the liberalization of entry was essentially complete. Two tasks remained for the Reagan administration: litigation of an antitrust suit brought against AT&T during the Ford administration, and the adaptation of federal and state regulatory policies to the new competitive world.

The AT&T Suit. For more than six years before President Reagan took office, the Justice Department had been preparing to try a massive suit against AT&T under Section 2 of the Sherman Act. The suit was brought on the theory that AT&T had monopolized long-distance service and equipment manufacture largely through the exclusionary practices of its local operating companies. Initially there was considerable speculation that the Reagan administration would either drop this case or settle it with relatively little damage to AT&T—much as the Eisenhower administration had settled an earlier suit that sought to break up AT&T. The "Reagan revolution" was not built on a platform of trustbusting. Several attempts were made to settle the AT&T suit, but each failed, including an attempt in 1981 by the Reagan Justice Department.

In the fall of 1981, after the government had completed its case against AT&T, AT&T received a rude jolt. The presiding judge in the case, Judge Harold Greene, ruled against AT&T's motion for summary judgment, noting that the corporation would be hard-pressed to succeed in defending itself against the government's charges. With this ammunition, the Reagan antitrust chief, William Baxter, was able to negotiate the largest antitrust divestiture since the 1911 breakup of Standard Oil. A decree was entered in 1982 that required the Bell operating companies to be spun off from AT&T, effective January 1, 1984. In return AT&T was freed from the Eisenhower-era decree limiting it to regulated telecommunications services.

The court order includes other important changes as well. It requires that the divested Bell operating companies provide equal access to all competitive long-distance carriers, and it limits these BOCs to the provision of service within Local Access and Transport Areas (LATAs). The BOCs are prohibited from offering long-distance service among the LATAs, from providing enhanced "information" services, and from manufacturing equipment.

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Since the divestiture, long-distance markets have become increasingly competitive as MCI and Sprint have increased their share of the market substantially. There has been a rush of investment in expensive fiber-optic networks to compete with AT&T, triggering concern that capacity may exceed demand and that many of the new carriers may prove not to be economically viable. Since AT&T is still regulated by the FCC, there is a distinct possibility that political pressures will force the commission to keep a floor under AT&T rates to preserve the viability of the newcomers.

Equipment manufacture also has become much more competitive because the BOCs are no longer compelled to purchase from AT&T. Switching equipment, transmission equipment, and terminal equipment are now supplied by a number of different sellers, including an increasing number of foreign firms.

Repricing the Telephone System. Prior to the AT&T divestiture, federal and state telephone regulators had succeeded in allocating a large share of local telephone plant costs to interstate long-distance services. This kept long-distance

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rates from falling as rapidly as they would have in a competitive market, and allowed local access rates (the fixed monthly telephone bills) to remain artificially low. This strategy was defended as a means of assuring universal service, but it was also very appealing to hundreds of politically sensitive state regulators. Since business customers accounted for a significant share (now about 60 percent) of long-distance revenues, residential subscribers were essentially being subsidized by business subscribers. The overpricing of long distance became an important attraction to new entrants.

Until divestiture the division of long-distance revenues between AT&T's Long Lines and the operating companies took place through a complex settlement process among AT&T's divisions. After divestiture the FCC was forced to institute a formal system of interstate access charges to be paid by long-distance carriers to the divested BOCs and the independent telephone companies.

To its credit the FCC quickly realized that charging high interstate access charges just to keep local rates low is inefficient; it also contributes little to universal service and invites bypass of the local companies' circuits. By 1981 fully 27 percent of the fixed (nontraffic-sensitive) costs of local subscriber plants were being recovered from interstate long-distance calls that accounted for only 8 percent of minutes of use.

After announcing the AT&T divestiture the Reagan FCC began to look for alternative, more efficient ways to defray these costs. It proposed a set of fixed "subscriber line charges" (SLCs) to be paid on a monthly basis by all subscribers regardless of their use of the network. These charges were scheduled to be raised gradually over time, eventually reaching $6 per month for residential users. The logic of such charges is that because a large share of subscriber plant costs do not vary with calling volume, subscribers should pay for these nontraffic-sensitive costs on a fixed monthly basis, not through usage-sensitive charges on long-distance calls.

State regulators and members of Congress, of course, were loath to allow such a repricing of telephone service simply because it was efficient. Facing a popular backlash against rising local rates, they pressured the FCC to keep the residential SLC from rising above $2.60 per month through mid-1988. In 1989 this charge will rise to $3.50 per month. The multi-line business rate, by contrast, was allowed to rise to $6 very quickly.

The imposition of SLCs, as well as regulatory lag, caused local rates to rise much more rapidly through 1986 than the general rate of inflation. As a result, the FCC received a storm of criticism for its sensible decision to reprice telephone service. Now that local rates have once again begun to fall relative to the overall rate of inflation, this political opposition seems to have abated. The share of households subscribing to telephone service continues to rise. (This fact should put to rest the notion that requiring American households to pay the true cost of connecting to the network will cause very many of the poor, old, and disadvantaged to abandon service.)

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Deregulation of Long Distance? Generally lost in the debate over telephone repricing was the fact that the AT&T decree was based upon a theory that equipment manufacture and long distance would quickly evolve into competitive markets and thus be free from regulation. Deregulation of terminal-equipment markets was complete by the time of the decree, but long-distance services continued to labor under the heavy hand of the FCC and state regulatory commissions—as they still do today, even though 87 percent of all local lines are reached by switches that offer equal access to long-distance competitors. The FCC continues to regulate AT&T's interstate long-distance rates under its "dominant carrier" policy. The smaller competitors essentially escape regulation, but they have a considerable stake in making sure that the FCC continues to regard AT&T as dominant. The FCC appears unwilling to consider lifting the regulatory yoke from AT&T, preferring instead to search for more efficient regulatory schemes.

Realizing that rate-of-return regulation stunts a carrier's incentive to be efficient, the commission this year proposed a system of price caps as a substitute form of regulation. These price caps would allow AT&T to raise rates by an amount not to exceed the rate of inflation less 3 percent per year. Responding to the political pressure

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created by AT&T's rivals, the commission also proposed to limit AT&T's right to reduce rates.

Swimming Against the Tide. Throughout the period since divestiture, the Reagan FCC has been battling Congress and state politicians who resent the disappearance of the old residential and rural subsidies. Congressional leaders have threatened to block the price-cap proposal. They have succeeded in limiting the use of SLCs in pricing a subscriber's local loop. And state regulators remain generally hostile to competition in intrastate markets because subsidization obviously requires that some services be priced *above* cost.

If one were to fault the FCC at this point, it is for not articulating a clear vision of how the interstate telephone market can be totally deregulated. Given the history of transportation regulation, we know that continued rate regulation and liberalized entry are a potentially lethal combination. Regulators inevitably find themselves hostage to inefficient competitors.

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It now appears that investment in interstate telephone transmission has been excessive. The frantic investment in fiber-optic networks reminds one of the rush to build railroad lines in the last century. It would be propitious for the regulators to find a way to exit before they are either pressured to keep long-distance rates artificially high or are engulfed in a series of politically embarrassing bankruptcies. Price caps should be seen as a transition to deregulation, not as a substitute for older, inefficient regulatory mechanisms.

Broadcasting

Broadcasting remains a government-created and -protected oligopoly that no administration seems willing to confront directly. Frequency allocations in the television and radio service bands are politically inviolate. Over time, however, new media arise to compete with the entrenched oligopoly. Video cassettes, cable television, and direct satellite broadcasting have emerged as potent competitors, but they have not yet driven the value of FCC-conferred broadcasting licenses to the scarcity value of the spectrum.

The major issues in broadcast regulation addressed by the Reagan FCC include program ownership, license renewal procedures, and the Fairness Doctrine. Of these, only the Fairness Doctrine is of major moment.

Fairness Doctrine. For decades the FCC has struggled with the consequences of its own decision to create market power in broadcasting by limiting the number of stations in each market. To protect the "helpless public" from the caprice of powerful station owners, it erected the Fairness Doctrine, requiring broadcasters to air controversial issues in an impartial manner. Critics claim that this policy inhibited broadcasters from addressing many controversial issues, and that such a policy was inconsistent with the promotion and protection of free speech. They point out that newspapers are not bound by such a doctrine.

There have been many attempts to modify or limit the application of the Fairness Doctrine, but the Reagan FCC was the first to vote for its abolition. Congress reacted by approving legislation to reinstate the doctrine but the president vetoed it. The legislation then was attached to a major spending bill, and when the president threatened to veto this bill, Congress blinked. The Fairness Doctrine is no more, although it is likely to return in a Democratic administration. If it does return, there is a good chance the Supreme Court will be asked to decide whether it violates the First Amendment.

Program Ownership. The battle over financial interests in television programming was short-lived. In the 1960s the FCC developed yet another fit of conscience over its creation of monopoly power in television. Rather than reduce this monopoly power by expanding television-frequency allocations or by liberalizing restrictive rules on cable television, the commission enacted new limits on networks' ownership rights in the programs they aired. In the same proceeding, the FCC limited network hours during prime time (thereby making millionaires out of Goodson-Todman and Merv Griffin, who rushed into the vacated half-hour each evening with socially uplifting game shows).

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The limitation on network programming during prime time remains, presumably because the FCC believes that the best antidote to network power is a requirement that the oligopolists reduce output even further. The FCC flirted with the idea of repealing the rule that barred networks from owning interests in future "syndication" of their programs. This proposed change in rules was, however, quickly abandoned when the antagonists, the motion picture companies, discovered that they had an ally in the White House.

License Renewal. In 1984 the commission eliminated its nonsensical "ascertainment" requirements for television station licensees. Under this policy station owners were supposed to canvas their communities to ascertain the breadth of interest in various types of programs and events. They were then supposed to structure their program offerings to reflect the findings.

In practice the ascertainment procedure was simply used as a lever for extortion. Because most programming of any substantial value is produced for a national market, station owners are forced to choose their programming from national networks or national syndicators of network reruns, movies, or other film-tape programming. The fact that, say, 1.63 percent of the local audience has a Polish heritage and that 5.67 percent of them say that they would like one hour per week of programs dealing with Polish-American culture is of little consequence. No station owner in his right mind would offer such programming unless it were free and could be aired at 4 a.m.

In practice the FCC simply buried ascertainment reports, dusting them off only occasionally when it received either a petition to deny the renewal of a license or a competitive application for the license. These applications never succeeded, of course, but applicants could persist until they were satisfied that the local broadcaster had fulfilled his requirement to broadcast in the public interest. (Satisfaction may have peaked in the late 1970s when a challenger to a New York television station licensee dropped his challenge after the broadcaster agreed to pay him several million dollars.)

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Mercifully, the FCC eliminated most of the silly programming, commercial-minute limitation, and ascertainment requirements from the excess baggage of television regulation. A similar decision had been reached for radio broadcasting three years earlier. It would be desirable if it now followed up with a proposal to increase competition in broadcasting through changes in frequency allocations, but this may be hoping for too much. It is more likely that we will have to rely upon cable, VCRs, and other "new media" to effect the competition necessary to improve performance in video markets.

Cable Television

In the late 1970s the Carter FCC liberalized cable television rules considerably, removing restrictions on signal carriage that had been established in the previous decade. Unfortunately local municipalities continued to control the franchising process; they thereby regulated cable subscriber fees and siphoned off a large share of the economic rents into the hands of politically favored clients. For years this situation was viewed without alarm except when cable officials went to prison for bribing local politicians.

A change occurred, however, when would-be entrants went to court to challenge a municipality's right to grant a monopoly to a cable franchise. After at least one community lost this battle, Congress enacted a bill in 1984 essentially deregulating cable. If the FCC determines that there is "effective competition" in a broadcast market, cable rates are deregulated for all new systems. For older systems, only "nonbasic" services—the nonbroadcast signals—are deregulated. The commission's standards for effective competition under the new law have been rather lenient. As long as there are three local broadcast signals, a market is deemed to be effectively competitive. Municipalities still grant franchises in these markets, but they may not control rates.

Must-Carry Rules. Although the deregulation of cable was clearly a good idea, it placed the FCC in a difficult position regarding copyrighted

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programming. As cable spread to more than half the population, the commission was forced to reassess its "must-carry" regulations for local broadcast signals. Under an earlier policy, invalidated by the courts on constitutional grounds, the commission had required all cable systems to carry all local broadcast stations. For older systems with 12 channels or less, this requirement could mean that an attractive service—such as ESPN or HBO—would have to be excluded in order to make room for a PBS station or a marginal UHF commercial station. If HBO displaced a weak local station on the cable, a cable household would no longer be able to tune in this station, even occasionally, without disconnecting its cable lead. This was regarded as unacceptable.

In 1986 the commission reinstituted a limited must-carry rule that required cable systems to offer all local stations until switches were installed that allowed subscribers to switch from cable to an external antenna. This policy makes little sense, except that it reflects the pressures brought by broadcasters. One would have thought that broadcasters could offer to pay cable systems to carry their programs, but when cable and broadcast industry officials negotiated a compromise, the FCC simply instituted it.

Perhaps more important was the FCC's reexamination of the policy that granted compulsory licenses of broadcast material to cable systems at legislated copyright rates. This strange policy evolved as a means of subsidizing an infant cable industry so that it could compete with broadcast stations. Under 1976 copyright legislation, cable systems were given a compulsory license to retransmit commercial broadcast signals. At the time, the FCC limited the number of such signals that a cable system could import and essentially prohibited pay services.

By 1980 the limitation on broadcast-signal carriage and pay services had been eliminated. Nevertheless, the FCC expanded the scope of the compulsory license by giving cable systems the right to retransmit copyrighted programs that a local broadcast station had bought under an exclusive agreement. Broadcast stations, of course, had no reciprocal right to air exclusive cable programs.

This year the commission revoked its 1980 policy and once again granted to broadcasters the right to negotiate for exclusive use of a syndicated program in its geographic market. Cable operators are now forbidden to offer imported programs that infringe upon the exclusive agreements. This policy change reflects the commission's conclusion that attempts to limit contractual arrangements in distributing competitive syndicated programming reduce program supply and thereby reduce economic welfare. It remains to be seen if the compulsory license provision in the 1976 Copyright Act also comes under attack as an anachronism in this era of mature cable television.

Conclusion

The Reagan administration's record on telecommunications has been remarkable. The breakup of AT&T and the attempt to bring some rationality to telephone pricing will surely look better and better in the coming years. Competition in telephone equipment and services is growing rapidly. Equipment prices are falling. With private users free to choose among various equipment suppliers and service vendors, service offerings are proliferating. It is no accident that Japan and the United Kingdom are now following our lead in telecommunications policy.

In the area of broadcast and cable there has also been substantial progress—despite the political land mines in regulating a medium that offers nightly editorial comment on local and national leaders. We are moving steadily to a less regulated video environment, one in which the public's demand for more movies and sports is amply supplied. Several major questions loom ahead. Will the cable industry be asked to shed its subsidized compulsory licenses of broadcast signals? When will the nation's telephone companies be allowed to bring even more channels into the home via fiber optics? And to what extent can the allocation of property rights in the electromagnetic spectrum be made more efficient? □

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U.S. Trade Policy

William A. Niskanen

U.S. TRADE POLICY turned sharply protectionist during the Reagan years. Moreover, *all* of the new trade restraints imposed were initiated or approved by the administration, despite a general endorsement of free trade in its public rhetoric. The cost of trade protection to American consumers was about $65 billion in 1986, an increase of nearly 100 percent since 1980. About one-quarter of the products imported by the United States are now subject to trade restraints, an increase from about one-eighth in 1980. Since no major trade legislation was enacted until the Omnibus Trade Act of 1988, this deterioration in U.S. trade policy was implemented largely without any major changes in trade law. The Reagan administration must bear the primary responsibility for this record. This article addresses the following questions: What happened to U.S. trade policy and why? Where do we go from here?

Administration Measures

Only a brief summary of the major trade cases during the past eight years is needed to convey the scope and nature of the administration's import policies.

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Automobiles. Following a campaign pledge that "one way or another . . . the deluge of [Japanese] cars must be slowed while our industry gets back on its feet," and the introduction of a Senate bill that would sharply limit the import of Japanese cars, the Reagan administration pressured the government of Japan to impose a "voluntary export restraint" (VER) on car exports to the United States. The agreement limited exports to 1.68 million cars through March 1982. To counter congressional pressure for a "domestic content" bill, the Japanese maintained this limit for two more years, then increased it to 1.85 million cars in the fourth year. Although the Reagan administration did not ask the Japanese to renew the export agreement in 1985, the government of Japan, for its own reasons, has maintained an annual limit of 2.3 million cars since that time.

The gains accruing to the two nations under this agreement have been predictable, if lopsided. For Japan, the agreement increased prices and profits of Japanese auto firms, increased their relative sales of higher-value cars, increased their production in the United States, and increased the control of the Ministry of International Trade and Industry (MITI) over their auto industry. (See Arthur T. Denzau, "The Japanese Automobile Cartel," *Regulation*, 1988 Number 1.) The U.S. auto industry got higher prices, profits, and employment, and American consumers got to pick up the tab—about $5.8 billion in 1984, or about $105,000 per job saved in the domestic industry. (These estimates of consumer losses, and those for the industries below except steel,

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were made by Gary Hufbauer, Diane Berliner, and Kimberly Elliot.)

The VER with Japan was entirely "extralegal" in that it was not authorized under U.S. law or under the General Agreement on Tariffs and Trade (GATT). It nevertheless set an unfortunate precedent for the administration's response to most other major trade cases.

Textiles and Apparel. As a candidate, Reagan also pledged to "relate" the growth of imports of textiles and apparel to the growth of domestic sales. In response to this pledge the administration decided in 1981 to renew the MultiFiber Agreement (MFA) in a form that would meet this goal. (The MFA, an outgrowth of the "short-term" cotton agreement of 1961, is a complex system of quotas set by the industrial countries on textile and apparel imports from developing countries.) The continued growth of imports led the administration to broaden the products covered by these quotas and to change the country-of-origin rules.

For the exporting countries the effects of these measures were similar to those of the auto quotas: increased prices, profits, and government control of their textile and apparel industries. The United States got increased prices and profits and a slower decline in employment in the domestic firms. The cost to American consumers was about $27 billion, or about $42,000 per job saved in the domestic industry.

For three decades the United States has been the prime mover in establishing a worldwide cartel for textiles and apparel sales, the only commodity group (other than agriculture) that is exempt from the normal GATT rules. The primary effect of the Reagan measures was to increase the scope and cost of this cartel.

Steel. In response to a 1982 petition by the steel industry for antidumping penalties and countervailing duties against imports of carbon steel from European firms, the administration arranged for VERs for steel. Under the agreements, steel imports from Europe were limited to 5.5 percent of the U.S. market, and a similar limit was placed on pipe and tube imports. Negotiations were initiated to achieve similar limits from other countries. The quotas established under the agreement were independent of the amount by which a country's or a firm's products were determined to have been dumped or subsidized; an "unfair trade" case was thus transformed into a general limit on European steel exports to the United States, irrespective of the extent to which individual firms had been charged with unfair trade practices.

In response to a 1983 "escape clause" petition from the specialty-steel industry, the administration imposed a set of tariffs and quotas on imports of selective specialty-steel products. Total steel imports, however, continued to increase, primarily from countries not included in these agreements. When another such petition was filed by the steel industry in 1984 and a bill was introduced to limit all steel imports, the administration decided to seek VERs from all major steel exporting countries. It sought to limit total imports of finished steel to 18.5 percent of the U.S. market as well as to limit imports of semifinished steel. Strong U.S. demand and a delay in negotiating and implementing these VERs, however, reduced their short-term effects; between 1984 and 1986, total steel imports declined from a peak of 26.4 percent of the U.S. market to 23 percent.

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Together these measures effectively created a worldwide cartel of steel exporters to the United States, increasing the prices and profits of firms receiving quotas and increasing government control of these firms. The U.S. steel industry experienced higher prices and profits and a slower decline in employment. The annual cost to American consumers was about $6.5 billion, or about $750,000 per job saved in the domestic industry! Since steel is a major input to other products, these measures also reduced the international competitiveness of other American industries.

Semiconductors. In 1986 the semiconductor industry petitioned to impose antidumping duties on imports of general-purpose memory chips from Japan. The price of Japanese chips was *higher* in the United States than in Japan, but was lower than the cost of Japanese production as estimated by the U.S. Department of Commerce.

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As in the 1982 steel case, the administration chose to negotiate a broad agreement with the exporting country, rather than to impose the duties authorized by law. Under pressure from the U.S. government, the Japanese government agreed to set a floor price on memory chips sold in the United States equal to the "fair market value" (as determined by the Commerce Department), to set a similar floor price on sales in third countries, and to promote an increase in the sales of U.S. chips in Japan. In the absence of this agreement the United States would have no authority to impose the latter two conditions. In 1987 the administration determined that Japan had not met the second and third provisions of this agreement (although it would not reveal the data on which it based this determination). It then imposed 100 percent tariffs on $300 million worth of other Japanese imports. In fact, the government of Japan had already ordered a substantial reduction of chip production to reduce the large inventory being sold in third countries; it also had implemented several measures to promote the sale of foreign chips in Japan. Although the administration later determined that Japan had ceased "dumping" in third countries, it maintained the punitive tariffs on a reduced set of products to induce Japan to increase the U.S. share of its chip market.

In effect, the semiconductor agreement created a two country memory-chip cartel. Combined with steady demand growth, the agreement led to a sharp increase in the price of memory chips in both Japan and the United States, from $2.50 in early 1986 to $5.50 in March 1988. Since chips are a major input in the production of computers, the agreement will reduce the international competitiveness of the much larger computer industries in both countries.

Other cases. There was no consistent pattern in the administration's handling of other trade cases. On the one hand, the administration established (in 1981) a system of quotas on sugar imports to maintain the domestic sugar price; these quotas were progressively tightened and later extended to the import of food products containing even minimum amounts of sugar. As of 1984, the domestic price of sugar was about four times the world price—the highest effective tariff on any legal product—at a cost to American consumers of about $1 billion. The administration also set a high temporary tariff on large motorcycles (in 1983) to protect about 2,000 jobs in one company; it requested (in 1986) VERs on imports of machine tools from four countries, after rejecting two prior petitions for restraints under different sections of U.S. law; and, during the sensitive early negotiations on the U.S.-Canada free-trade agreement in 1986, the administration imposed substantial tariffs on imports of cedar shingles and softwood lumber from Canada.

On the other hand, the administration rejected or removed trade restraints on three products. The administration rejected petitions (in 1981 and 1985) to continue or reimpose quotas on footwear. It rejected a petition (in 1984) to limit copper imports because of the adverse effects on the much larger copper products industry. And it convinced Congress (in 1986) to delete the "manufacturing clause" in copyright law that required most books and magazines to be printed and bound in the United States in order to receive U.S. copyright protection (a provision that dated from 1891). The footwear and printing industries are the only industries for which trade restraints are now substantially lower than in 1980.

Export Measures

The administration's export policies are best described as inconsistent. The administration removed the embargo on grain sales to the Soviet Union but imposed an embargo on the sale of U.S. equipment and U.S.-licensed equipment made in Europe for the natural gas pipeline from the Soviet Union to Europe. After a protest from European governments, this embargo was removed. For foreign policy reasons the administration imposed selective embargoes on trade with Poland, Libya, Nicaragua, Syria, and, in response to strong congressional pressure, South Africa. Several times the administration proposed reducing funding for the Export-Import Bank while simultaneously agree-

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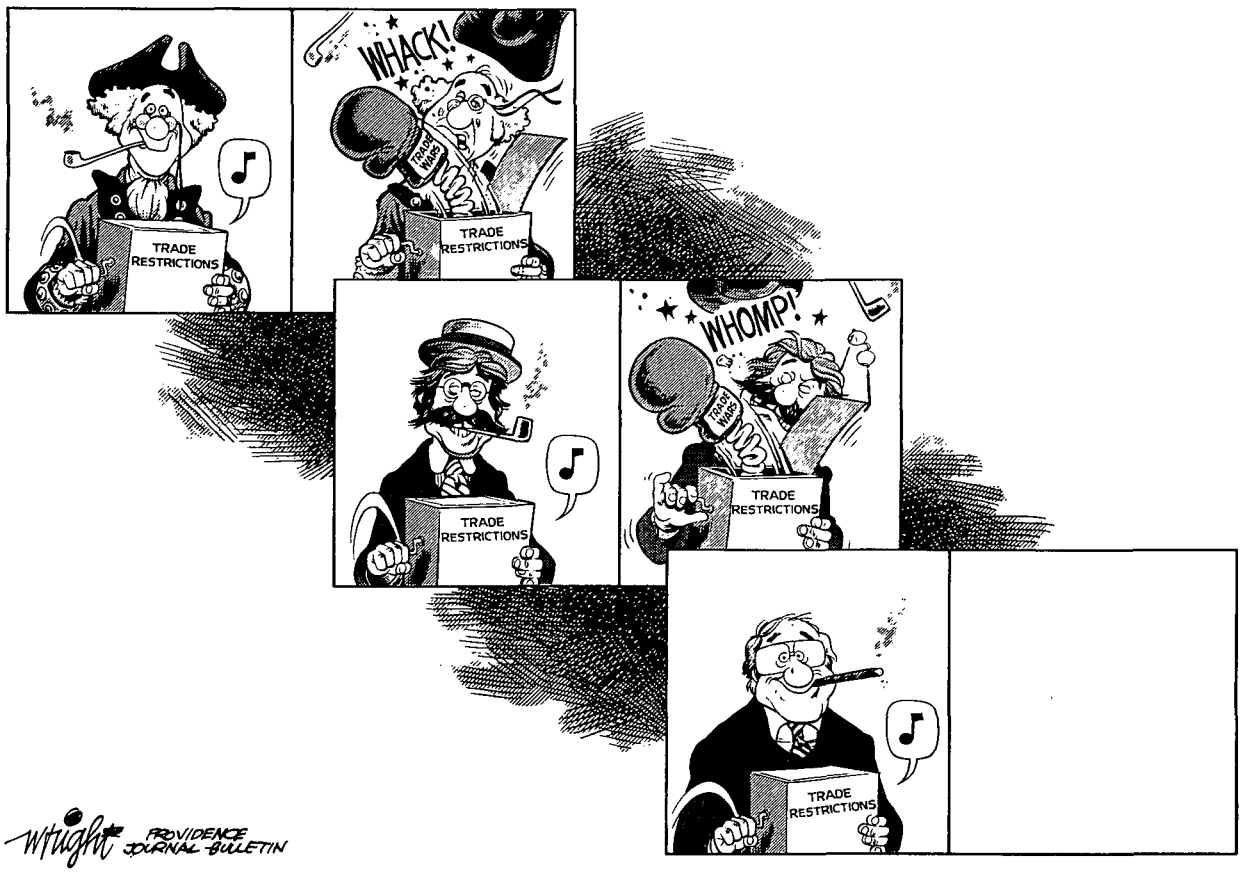

ing to increase subsidies on agricultural exports. The administration did not ask Congress to remove the bans on exporting logs or Alaskan oil, or the requirement that 50 percent of all government-financed agricultural exports be carried on American ships. American firms still lack clear guidelines on the export of defense-related technology that are consistent with the rules affecting sales by other Western nations. For many years the federal government has promoted the export of some products and restricted the export of others, with little apparent rationale. For the most part, this is still the case.

At the same time, however, the administration stepped up pressure on other governments to open their markets to U.S. goods. The general tactic was to threaten limits on their exports to the United States in order to induce them to reduce their limits on U.S. sales in their markets. The Reagan administration initiated 10 such cases during its first term and 22 such cases after September 1985, when trade policy became markedly more aggressive. These measures had some success. Japan reduced or eliminated tariffs on aluminum products, cigarettes, and leather products, and substituted high tariffs for very restrictive quotas on beef and citrus. Korea reduced its barriers on U.S. movies and television programming. Taiwan opened its market to beer, wine, and cigarettes. Europe reduced restraints on imports of corn and citrus. And so on.

But this tactic, by its nature, risked imposing substantial costs on the United States, both in terms of higher U.S. trade barriers and an erosion of our bargaining leverage on more important issues. For example, in response to a loss of corn sales to Spain and Portugal upon their joining the common market, the administration threatened to impose a 200 percent tariff on imports of selected alcoholic beverages and agricultural products from Europe. The escalation of this dispute was only narrowly averted. Threats of steep U.S. duties on European spaghetti and fancy pasta sold in gourmet groceries became even more tangled, with the European Commu-

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nity retaliating against U.S. walnuts and lemons, the U.S. delaying concessions on semifinished steel, and Europe imposing duties on U.S. fertilizer, paper products, and beef tallow. One might hope that America's limited leverage with major allies would be focused on more important issues, such as our shared defense burden. Threatening to impose costs on both U.S. consumers and foreign producers in order to increase the benefits to U.S. producers, generally over trivial issues, may turn out to be a game of Russian roulette.

Congressional Measures

Congress also bears substantial responsibility for the deterioration in U.S. trade policy during the Reagan years. Although little trade legislation was approved until 1988, a large number of trade bills were introduced, and a few were passed by one or both houses. Heading off these bills became the administration's primary internal rationale for its own protectionist actions.

During Reagan's first term Congress was stepping up pressure for protectionist trade legislation, but its signals were still mixed. Congress overrode a veto to extend the manufacturing clause of the copyright law, but subsequently allowed this provision to expire. Twice the House approved a bill that would have required domestic production of up to 90 percent of the value of all cars sold in the United States, but on both occasions the bill died in the Senate. A more general Trade and Tariff Act was approved in 1984, after an extraordinary effort by William Brock (the U.S. Trade Representative in the first term) to delete most of the small protectionist provisions. This act strengthened the authority to retaliate against unfair trade practices, broadened the definition of injury in escape clause cases, and included a small number of minor protectionist provisions; on the other hand, it reduced tariffs on about 100 products, extended the Generalized System of Preferences on imports from the developing nations, and provided authority for bilateral negotiations for free-trade agreements with specific nations.

The primary problem with the act is that it represents a unilateral U.S. declaration of the rules of trade.

Trade policy turned more aggressive in the second term. In 1985 the House passed a bill to tighten the quotas on textile and apparel imports and the Senate passed a similar bill, adding protection for the copper and footwear industries that had been denied relief by the president; this bill, however, was subsequently vetoed. In 1986 both houses began to develop comprehensive trade bills, focusing on trade authority and rules rather than on specific products. The general thrust of these bills was to broaden the conditions that would be defined as unfair trade practices, restrict the presidential authority to deny trade relief, and (for a few goods and services) to require a "reciprocal treatment" of U.S. sales in foreign markets and foreign sales in the U.S. market. Two years of deliberations on this legislation culminated in the Omnibus Trade Act of 1988, the 1,000 page trade bill passed by large margins in both houses. The president's response to this legislation was remarkable. He first vetoed the bill, objecting primarily to a provision requiring early notice of plant closings and substantial layoffs. When Congress responded by passing a separate plant closing bill, the president endorsed the trade bill and chose not to veto the plant closing bill.

Only a few provisions of the Omnibus Trade Act are likely to be trade-expanding: the president is granted special authority to negotiate the new GATT round; the rules affecting U.S. business practices in other countries are made more realistic; tariffs are reduced or eliminated on many products for which there is no U.S. source; and the "windful profits" tax on U.S. oil is repealed. These provisions came at a very high price, however.

The primary problem with the act is that it represents a unilateral U.S. declaration of the rules of trade. It reverses 40 years of U.S. leadership toward a set of trade rules to which all parties agreed. In effect, the United States has told the rest of the world, "Play by our rules or we will not buy your products"; in the name of reducing unfair trade by other countries, the United States changed the rules of trade by an unfair process. One should not be surprised by strong foreign opposition to this act or by the prospect of other countries applying unilateral rules to the United States.

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International Agreements

One creative instrument of trade policy initiated during the Reagan years was the bilateral free-trade agreement with selected countries. A free-trade agreement with Israel was approved in 1985, for example, and a broad agreement with Canada, our largest trading partner, has recently been approved. A "framework agreement" with Mexico, our third largest trading partner, will provide guidance for future trade negotiations. Such agreements have been considered with other countries.

Bilateral free-trade agreements promise to increase the benefits of trade to each participating country. In addition they expand the dollar-bloc free-trade area, which can provide leverage—perhaps our only substantial leverage—to achieve a desirable outcome from the new round of GATT negotiations. The United States entered these negotiations in 1986 with an ambitious agenda to broaden GATT rules to agriculture, services, and investment. The prospects for this round, however, are not encouraging. The Europeans have strongly resisted the elimination of trade-related agricultural subsidies and are more concerned about completing the integration of the European Economic Community. And most countries have been provoked by the more aggressive U.S. trade policy of recent years. In the absence of creative leadership, the world trading system may well devolve into regional trading blocs with higher barriers to trade among blocs—a sad outcome for an administration that was once committed to "improvements and extensions of international trade rules."

The Political Economy of Trade Policy

What explains the substantial change in U.S. trade policy during the Reagan years?

First, when the Reagan administration came to office, it had no strong, consistent convictions on trade policy. Indeed, the president and other key officials never resolved the tension between their public pro-market rhetoric and their private pro-business sympathies. The initial statement of the Reagan economic program barely acknowledged the international dimensions of economic policy. One paragraph described how the proposed policies were expected to improve international conditions, but there was no mention of the principles that would guide our economic relations with other nations. Increased spending for defense and business investment was a major objective of the initial program, but there was no recognition that these measures would have a substantial effect on the real exchange rate and the trade balance.

Fortunately the administration developed a more comprehensive statement of U.S. trade policy in mid-1981. The primary theme of this statement was "free trade, consistent with mutually accepted trading relations." It committed the administration to five specific trade policy objectives which, given the economic conditions anticipated in 1981, would have been a satisfactory and sufficient framework for trade policy. Unfortunately these conditions did not prevail.

Second, adverse economic conditions in the early 1980s—the long recession and the rapid increase in the exchange rate and trade deficit—led to strong pressure from business, unions, and Congress for selective trade restraints. This pressure, in combination with some 1980 campaign

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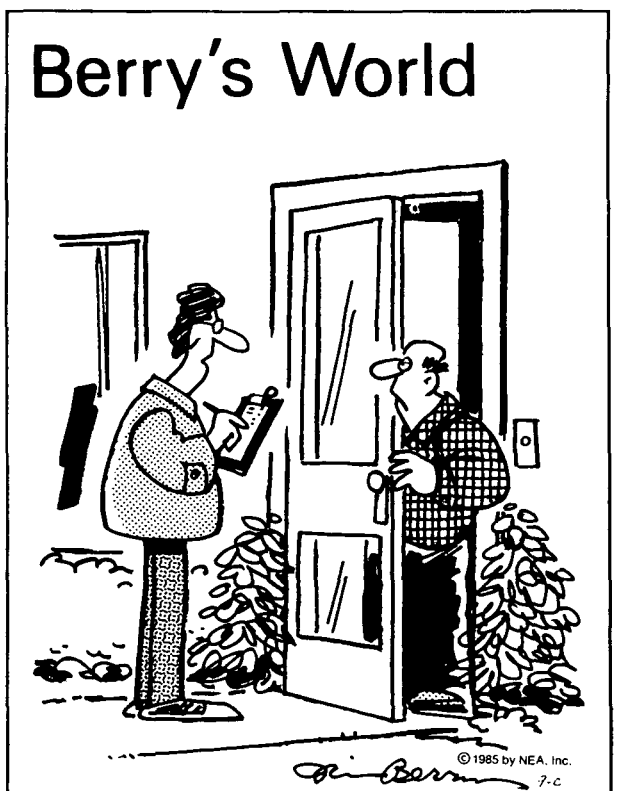

"You like protectionism as a 'working man.' How about as a consumer?"

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commitments and controversy within the administration, led to numerous breaches in the announced trade policy.

Third, even after the economy rebounded, the increasing disparity between the announced trade policy and the developing trade record was resolved by changing the official trade policy, rather than by correcting the record. In 1985 a draft speech prepared for the president that would have renewed his commitment to free trade was revised, under the auspices of White House Chief of Staff Donald T. Regan, to conclude that "if trade is not fair for all, then trade is 'free' in name only." The major element of Reagan's new Trade Policy Action Plan was the initiation of a series of actions against "unfair" trade practices by other governments, including practices not covered by existing GATT rules. This unilateral definition of fair trade was a major change from the announced trade policy of the first term and set the stage for the broader U.S. definition of fair trade in the trade bills being developed by Congress. This change in policy was roughly coincident with the appointment of Clayton Yeutter as the new U.S. Trade Representative and with Secretary of the Treasury James A. Baker III's Plaza Agreement for coordinated action to devalue the dollar, which signaled a more interventionist policy on a range of international economic issues.

Finally, trade policy became a major focus of the special interest demands for government benefits. While the total demand for such benefits may be roughly constant, several major changes in economic policy during the Reagan years—specifically the substantial reduction in real spending on discretionary programs, continued economic deregulation, and broadening of the tax base in the Tax Reform Act of 1986—reduced the special benefits distributed by other means. The large budget deficit continues to constrain the potential to distribute special benefits through the budget and tax code. This is likely to create continuing demands for special benefits through trade policy (as well as through new types of economic regulation such as mandated benefits).

While the administration rationalized its major protectionist actions and, ultimately, the shift in its announced trade policy as necessary to head off even more aggressive measures by Congress, the outcome of this strategic retreat was not satisfactory. For the first time since World War II the United States added more trade restraints than it removed. Although U.S. pressure led to some reduction in trade-distorting practices, it also consumed political capital that continues to be important in GATT and other international forums. And the Omnibus Trade Act of 1988 ended a half-century of U.S. leadership toward a more open world trading system based on mutually accepted rules of trade.

The Prospects for U.S. Trade Policy

Where do we go from here? For the next several years U.S. trade policy is likely to be increasingly aggressive—despite a sustained economic recovery, a declining trade deficit, and a sharply lower foreign-exchange value of the dollar. Both presidential nominees, George Bush and Michael Dukakis, endorsed the Omnibus Trade Act while generally supporting free trade. Congress is in an ugly mood, both about foreign trade practices and foreign investment in the United States. The Omnibus Trade Act, best described as "procedural protectionism," invites an increasing number of petitions for trade restraint and requires more administration investigations of foreign trade practices. Since the president and the U.S. trade representative still retain a measure of discretion in implementing trade measures, U.S. trade policy will continue to be dependent on how the new administration uses this discretion. My own judgment is that the prospects for the new GATT round are not encouraging, unless the United States develops an effective strategy to break the logjam on agricultural issues.

We now need to develop a longer-term strategy to preserve and extend free trade. Supporters of free trade have been too defensive for too long.

We now need to develop a longer-term strategy to preserve and extend free trade. Supporters of free trade have been too defensive for too long—opposing or trying to limit new trade restraints, but rarely proposing reductions in trade restraints. This is a no-win strategy. When we win, it is a draw; when we lose, the scope and level of trade restraints are increased. What is needed is an *offensive* strategy to *reduce* trade

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restraints, both in the United States and abroad, with the hope of shaping the perceptions that will affect U.S. trade policy well into the next century.

What might be the elements of such a strategy? The following general approaches should be considered.

First, and most important, we need to regain the moral and economic high ground for free trade. The fundamental moral case for free trade, both within nations and between nations, is based on the principle of consent. The most important role of government is to secure the rights of individuals to make consensual arrangements of any kind that do not affect the rights of others, including arrangements across national borders. The economic case for free trade is that it increases the combined income of the affected nations and, except in rare conditions, also increases the income of each nation. This perspective on international trade is now more threatened than at any time in the postwar years.

Many supporters of free trade, unfortunately, became too involved in the narrow politics of current issues to recognize the power of ideas in shaping legislation. During the past decade, however, three of the more important changes in U.S. economic policy were the result of a convergence of *elite* opinion, across parties and without any significant popular pressure. These changes were the substantial reduction of domestic economic regulation, the Gramm-Rudman-Hollings deficit reduction process, and the Tax Reform Act of 1986. We need to reassert the moral and economic case for free trade so that, at some point in the future, free trade will be similarly recognized as an idea whose time has come.

Second, we need to support measures, both in the United States and abroad, that reduce the U.S. trade deficit. A trade deficit is of no particular concern when domestic investment is unusually high. The current U.S. trade deficit, however, is the result of conditions that are neither sustainable nor desirable: the unusually low level of U.S. saving net of government borrowing. In effect, the U.S. trade deficit is providing the net inflow of goods and services to permit an unsustainable level of private consumption and government spending. There is no prospect for changing the direction of U.S. trade policy until these conditions are changed.

The primary responsibility for reducing the U.S. trade deficit, of course, must rest with the United States. The several types of measures that should be considered include reducing the remaining biases in our tax system against private saving, reducing the growth of government spending for both services and transfer payments, and, only if politically necessary, increasing taxes to reduce the growth of private consumption.

It is important to recognize that measures by other governments to increase their private consumption, defense spending, or domestic investment would also reduce the U.S. trade deficit. As a rule, and in contrast with many U.S. government officials, I am most reluctant to pressure other governments to change their domestic policies. In the case of defense spending, however, the current U.S. share of our common defense is disproportionate. The United States now spends about 6.5 percent of GNP for defense—about twice the share by our NATO allies and about five times the share by Japan. Our disproportionate share of the burden of providing the common defense is, in effect, one of our largest exports—but one for which we are not compensated. For various reasons the United States is likely to reduce its overseas military forces during the next decade, forcing the governments of Europe and Japan to reassess their own contribution to the regional defense against the continuing Soviet threat. An increase in defense spending by Europe and Japan that matches the reduction of U.S. defense spending would reduce the U.S. trade deficit by more than the amount of the shift in the defense burden. This is a complex issue but one that cannot be avoided by pretending it does not exist.

Third, we need to force the political pressures for U.S. trade restraints through the formal processes authorized by U.S. trade law and the GATT. Many of the U.S. trade restraints implemented since 1980 have been extralegal "voluntary" export restraints under which other governments have agreed to avoid a formal action under U.S. trade law. My own judgment is that the acquiescence of other governments, particularly Japan, to these restraints has been most shortsighted because it induced the United States to impose other such measures. The scope of U.S. trade restraints, I believe, would have been narrower if other governments had resisted U.S. pressure for such extralegal restraints.

Fourth, we need to broaden the use of bilateral free-trade agreements. Bilateral agreements serve two objectives: they broaden the dollar bloc of free-trade agreements in the absence of a more general agreement under GATT; and they put substantial pressure on the

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Europeans (who have expressed considerable concern about being left out of such agreements) to broaden and strengthen GATT in the current negotiations.

My views on this issue were reinforced by hearing the French agriculture minister's proposal (in the Chirac government) for cartelizing the world's major cereal exporters. The current European position on agricultural trade threatens to undermine any prospect for success of the GATT round unless the United States presents a credible threat of walking out of these negotiations. The GATT may increasingly become an instrument of *managed* trade, unless the United States presents a credible alternative framework for world trade—even if that alternative is less desirable than some conceivable multilateral arrangement. The U.S. bilateral initiatives should not be regarded as a threat to GATT but as part of a strategy to achieve a successful negotiation of a broader multilateral arrangement.

Finally, at some stage, we need to make the case for *reducing* the scope of U.S. trade law. My suggestions are the following:

- Exclude dumping, on either a price or cost basis, as a basis for duties. The dumping code, which is especially vulnerable to abuse under flexible exchange rates, penalizes foreign firms for practices that are regularly used by domestic firms. And accountants at the Commerce Department have amply demonstrated their creativity in identifying dumping under a wide range of conditions.

- Restrict countervailing duties to the amount of the *net* subsidy by foreign governments (subsidy minus the incremental cost of meeting specific domestic regulations). For example, a small German subsidy to steel mills offsets the requirement to use German coal. This is effectively a subsidy to German coal, not to German steel, and should not be a basis for a countervailing duty against German steel. Likewise, many governments subsidize firms that locate in specific regions. Such regional development subsidies typically offset the higher costs of operating in these regions, do not reduce the net cost of production, and should not be a basis for a countervailing duty. A net subsidy criterion would apply a countervailing duty only when the subsidy reduces the price at which the good or service could be sold on the world market.

- Restrict or eliminate the Section 301 authority for trade restraints. This section of U.S. trade law has been used to authorize retaliation on the basis of foreign practices that are wholly consistent with GATT and it has been subject to considerable abuse.

Such changes would channel pressures for trade restraints primarily through two existing sections of U.S. trade law, sections 201 and 232. Section 201 authorizes trade restraints when an increase in imports has been the major cause of injury to a domestic industry. This provision has the advantage of permitting the president to consider the interests of consumers and other industries in determining whether to approve or modify a recommended trade restraint, and requires compensation of the exporting country. Section 232 authorizes trade restraints when an increase in imports would threaten the industrial base necessary for national security. Even Adam Smith acknowledged that "defense is more important than opulence."

The process and criteria for approving trade restraints under these two sections of U.S. trade law are wholly consistent with GATT, and these sections have not been subject to substantial abuse.

In summary, we can develop a long-term strategy to preserve and extend free trade. This will require intelligence, a sense of realism, a commitment to principle, and considerable patience. Alternatively, we can simply respond to political pressures for new trade restraints and allow the world trading system to continue to deteriorate. The future of U.S. trade policy and of the world trading system depends on the outcome of this choice. □

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Environmental Policy

Richard L. Stroup

ON FEBRUARY 22, 1983, EPA Administrator Anne Gorsuch (later Burford) announced that the Environmental Protection Agency would pay $33 million to buy all the homes and businesses of the small Missouri town of Times Beach. This followed weeks of nationally publicized hysteria about the town's streets, which had been contaminated with dioxin more than 10 years earlier. Although there was no evidence that anyone in Times Beach had ever been harmed by the dioxin, Administrator Gorsuch traveled to Times Beach to announce the buyout personally and to demonstrate to the national media her concern with the risks of hazardous waste. Her demonstration was not enough. Less than two weeks later she was forced to resign—accused of, among other things, a callous disregard for such risks.

This extraordinary episode echoed the Love Canal disaster of the Carter administration. In 1978 the New York state health commissioner declared an emergency and urged women and young children to move from certain neighborhoods near a chemical waste site. The governor of New York, up for re-election, called for federal aid. The Carter administration quickly answered the call and provided the state federal aid in purchasing hundreds of homes. Massive publicity led to the evacuation of these homes and to the expenditure of millions of dollars—more than $250 million to date for a cleanup that is still unfinished. Yet, while there were allegations about medical effects, no credible evidence has been found that the chemical waste at Love Canal caused any long-term health problems.

Through Republican and Democratic administrations alike, the politicizing of environmental issues is a constant. Increasingly strict regulation, mushrooming tax and spending programs, and mandated private expenditures have been the result. Judging by the virtual absence of demonstrable benefits, these policies are seriously misdirected. Although long-term health problems from industrial waste sites, for example, are almost impossible to substantiate, we spend $8.5 billion on Superfund. This spending is predicated on the assumption that each and every hazardous waste site must be cleaned up to meet the same standard as drinking water. As a recent EPA study reported, "Overall, EPA's priorities appear more closely aligned with public opinion than with our estimated risks."

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The good news is that there is enormous room for improvement in the nation's environmental policies. A positive approach involving less political control could substantially reduce the cost of avoiding environmental risks while providing greater environmental benefits. This article seeks to explain the increasing role of politics and crisis in environmental policy, to examine the record of the Reagan years, and to outline a more positive policy agenda for future administrations.

The Common Law

Historically, individuals and their property have been protected against the invasion of chemicals and other pollutants primarily by nuisance and tort actions. Our system of individual responsibility under the common law has successfully screened us from the worst possible risks.

The key to the common law approach is accountability. Individuals who make decisions must be accountable for the results; that is, they must face penalties and rewards in line with what they do to society and for it. When people are accountable, they find ways to avoid errors and to react quickly and constructively when errors occur. People who are accountable have the incentive to act *as if* others matter, whether or not they truly care about the welfare of others.

One strength of the common law approach is that the rules of evidence and of standing in court have developed over the decades to prevent frivolous actions and to balance the interests of plaintiffs and defendants. To decide when and how much a polluter should pay in damages, or whether an alleged danger is severe and imminent enough to warrant prior restraint, a judge must be able to estimate the damages being imposed. Absent such estimates, rational control or compensation measures under any regime of protection are impossible. The primary job of courts is to make individuals accountable for what they do, not for what someone thinks or alleges they do. This is what rules of evidence are for, and they operate far more systematically in the courts than in the political process.

Another advantage of the common law is that it evolves in a process that cannot be controlled by lobbyists for industry, the environment, or any other particular interest. When judges impose prior restraint (injunctive relief) to prevent irreversible harm, they must follow rules developed over centuries to balance considerations of freedom, efficiency, and safety within the community.

Despite these advantages, the common law approach has been under siege from environmental activists for the better part of 25 years.

America's "Green"ing

Environmental activism exploded onto the American scene in the 1960s as politically active groups shifted their attention from atmospheric nuclear testing to chemical pollutants. The movement was fueled by the publication of Rachel Carson's *Silent Spring* in 1962. As in much environmental literature since that time, the rhetoric in *Silent Spring* was eloquent and full of strong emotions, but the supporting evidence was considered by many scientists to be one-sided and misleading. The book elicited fear and indignation and moved people to demand political action. "Those who would pollute and plunder the planet must be stopped!" was the message increasingly heard.

Silent Spring inaugurated the view that a whole new regime of governmental controls was required to protect the earth and its inhabitants from technological disasters. This view is still common and, when an environmental crisis stirs public concern, it is the driving force behind public policy.

For people moved by stirring prose of the sort in *Silent Spring* and fearful of new and developing technologies, the traditional common law system fails to provide adequate safeguards against environmental risks. In their view convincing evidence of environmental damage is unnecessary, and an economical means of preventing it is irrelevant. Any plausible threat of damage must be eliminated. Of course this is easy to say as long as large corporations are perceived to be the main culprits in pollution and they, rather than individuals, are presumed to pay the tab for prevention and cleanup.

Unfortunately the laws that result from this viewpoint are notorious for being expensive *and* environmentally ineffective. The reasons for this are clear. Politicizing environmental control does nothing to produce the information needed for effectively protecting us from pollution. When an agency tells polluters exactly what technology to use or what their emissions should be to

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protect society best, it is usually acting with neither essential data on pollution effects, nor important data on the cost of alternative control measures.

We are increasingly operating under a new regulatory regime, one partly based on common law principles but modified in important ways by statute. Among the important changes is the heavy burden of proof on anything new. New activities often are allowed only if shown to be almost "risk free"—as exemplified by the Delaney clause of the Food, Drug, and Cosmetic Act. Faced with the *potential* risk of new chemicals, drugs, or genetically altered microorganisms, politicians and bureaucrats are inclined to ban use until safety can be proven. As AIDS sufferers and the families of those who have died waiting for federal approval of new drugs can attest, "zero risk" is actually a very dangerous strategy. The unintended side effects of "uncompromisingly tough" environmental standards can be similarly dangerous. When DDT was banned because its misuse harmed some wildlife, more dangerous pesticides replaced it. (In less wealthy Sri Lanka the situation was worse: Sri Lanka withdrew from the World Health Organization's large-scale DDT spraying program, and the number of cases of malaria rebounded from a low of 110 cases in 1961 to 2.5 million cases in 1968-1969.) We cannot know just how many farm workers have died from DDT substitutes, but since the replacement pesticides are much more harmful to people and must be more frequently applied, the "risk avoidance" banning of DDT introduced far more human risk.

Overly conservative risk-avoidance policies are dangerous to society because they stifle technical and economic progress.

In general, overly conservative risk-avoidance policies are dangerous to society because they stifle technical and economic progress. Most research and development efforts in biotechnology have shown no clear and present dangers and, indeed, offer the promise of more effective waste cleanups and "softer" (less environmentally threatening) means of controlling agricultural pests and weeds. But again, the atmosphere of fear and even of crisis has meant that research, testing, and use of these techniques has been hampered needlessly by a web of regulations created by the EPA and the U.S. Department of Agriculture.

Furthermore, abandoning common law to seek shelter from risk in congressional statutes bestows power on organized special interests. Members of Congress, after all, do not have national constituencies, and helping important constituent groups is the name of the game. It is not surprising that many of the costly policies of the Clean Air Act have been used to fight regional economic battles and to protect the powerful eastern coal industry and its unions. Both the Clean Water Act and the Superfund program have funded massive local spending. Some good has surely come from these efforts. We spend an estimated $80 billion annually to control pollution, and some cities certainly have clearer air, and stretches of river immediately downstream of big new sewage treatment plants are noticeably cleaner. But the price is very high, and evidence of serious health harms prevented (that is, benefits achieved) is typically rare and tenuous.

The Last Eight Years

If anyone seemed likely to take a calmer view and restore the traditional common law system, at least in part, it was Ronald Reagan. Reagan rode into the White House on a wave of disenchantment with intrusive regulation and big government. He championed individual responsibility and less direct control by government.

Unfortunately this view did not influence the administration's environmental policy. The administration's policy pronouncements revealed little understanding of the role and purpose of private property rights protected by common law: holding decision makers accountable for environmental effects, while giving them the freedom to innovate.

A positive, pro-environment program could have been built on ideas floated internally by some Reagan appointees. For instance, the 1984 annual report of the President's Council on Environmental Quality included a discussion of the role of private property rights and devoted a chapter to case histories of important private conservation efforts. These histories showed that decades before environmentalism was a political

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movement, individuals, and groups in the private sector were helping preserve species, habitat, and natural settings, sometimes in direct opposition to public policy. Such efforts would have been doomed to failure if public lands or public-sector approval had been needed. The report made no apparent inroads, however, in defining the administration's agenda.

Similarly, William A. Niskanen, a member of the President's Council of Economic Advisers for most of the Reagan years and author of *Reaganomics*, reports that he proposed turning over more decisions and responsibilities for environmental protection to state and local governments. The benefits of controlling most pollutants are mainly local and, had these proposals been accepted, a diversity of approaches at the state level presumably would have been tried. Permitted emissions could be tailored to local needs, which vary dramatically with geography, population density, and climate. Both the Clean Air Act and the Clean Water Act, which were due for renewal during the Reagan years, offered opportunities to translate these ideas into policy.

An emphasis on federalism could have been coupled with national technical monitoring—to see that one state's pollution was not seriously harming another state's residents—and a national clearing house for technical information on pollution control. The Constitution provides for interstate compacts to help solve truly interstate problems. These steps would have been positive measures in keeping with both Reagan's philosophy and good environmental management.

Proposals of this sort were offered within the administration, but little was done to follow through. The EPA had little or no impact on the renewal of the Clean Water Act in 1987 or on Superfund.

The simple move toward transferable pollution permits, given to those already allowed to emit specific pollutants, would have been a giant step forward. Suggested by EPA staff economists among others, this approach was rejected by Gorsuch. Yet its advantages would be numerous. Valid information on the true costs of pollution control would quickly surface in the form of market-clearing prices for the permits. Any given level of control could be achieved much more cheaply. And the constant pressure for polluters to profit by reducing their use of permits would make them eager customers for new and better control technologies. Such technologies would further lower the cost of pollution reduction. Governments could purchase and retire permits in order to lower emissions, rather than engage in the destructive political battles that now accompany regulatory adjustments. Or conservation groups could purchase and retire them, just as they buy (and retire) development rights in land to preserve habitat or natural features.

The administration showed neither an appreciation of the political importance of environmentalism nor a vision of how to formulate an environmental policy that reflected the president's philosophy.

These constructive proposals had little impact because members of the Reagan administration, like most politicians, seemed to view environmental policy as a zero-sum game: if environmentalists gain, then other goals suffer. The

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administration showed neither an appreciation of the political importance of environmentalism nor a vision of how to formulate an environmental policy that reflected the president's philosophy. Simply streamlining regulations and procedures seemed to become the goal. In its eight years in office, the Reagan administration presented no alternative to Superfund and even supported amendments designed to strengthen the program. Command-and-control programs, criticized by liberal and conservative analysts alike, escaped serious reform.

In the two terms of the Reagan administration, however, there were some limited successes in environmental policy:

- The administration attempted to bring cost-benefit analysis to bear in the evaluation of environmental policies. Cost-based analyses are necessarily limited in value because without markets, there are no meaningful measures of consumers' willingness to pay to reduce or eliminate risks. Ultimately, better institutions, not better analytical techniques, are needed. The administration's efforts did succeed, though, in making costs more visible and in highlighting the skewed priorities of existing programs.

- The EPA's lead phasedown regulations replaced inefficient and inequitable regulatory standards with transferable, bankable lead-use permits for gasoline refiners. Transactions in the market were made completely private, without any requirement for government approval. The result was not only more cost-effective control of lead, but also a faster transition to today's nearly lead-free gasoline supply.

- Interior Secretary James G. Watt's coal policy sped up the leasing of federal coal and displaced coal from ecologically more disruptive mines. (Even though they were branded "firesale prices" by a hostile press, the new leases were, in retrospect, a very good deal for the U.S. Treasury.)

- The Coastal Barrier Resources Act (CBRA) stopped new federal subsidies for development on previously undeveloped coastal barrier islands. Both fiscal conservatives and environmentalists had long called for such a move, and Watt was a strong proponent. Unfortunately the administration failed to call for an extension of the concept to protect the areas around national parks. Environmentalists were (and are still) calling for more land acquisition for "buffer zones" to protect park values even though the approach contained in CBRA could be far more cost-effective. (While at the Interior Department, I suggested that such non-subsidy zones should extend for, say, 5000 miles in every direction from each park boundary; my suggestion was not deemed acceptable.)

- The administration grudgingly supported the idea of allowing federally delivered agricultural water to be traded for a profit, with part of the proceeds used to repay the costs of the water project; once again this had been called for by both fiscal conservatives and environmental groups (notably the Environmental Defense Fund). Such trades could generate much economic value and also ameliorate environmental problems in states like California where threats from irrigation drainage and new water diversion programs are quite serious. Even here though, the Reagan Interior Department held back. It failed to clarify departmental policy toward water transfers or to prepare a package of recommended amendments to reclamation law.

- The administration advocated the "sodbuster" and "swampbuster" provisions of the new farm bill, which reduced the degree to which agricultural subsidies caused farmers to till marginal fields or drain swamps and marshes that would otherwise be more valuable as wildlife habitat and hydrologically important wetlands.

The government is still trying to provide environmental quality the way the Russians grow wheat—with central, political control.

If local governments properly designate fragile lands and enforce the agreements reached with farmers, the worthy goal of reducing the substantial destruction caused by agricultural policy in recent years may be attained.

The Reagan administration's achievements were modest because they never addressed the heart of the problem. Instead of being aimed at reducing damage, current statutes make criminal many practices—the careful application of DDT for example—which normally are both produc-

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tive and safe. The government is still trying to provide environmental quality the way the Russians grow wheat—with central, political control—and trying to preserve land and wildlife with straight socialism, namely ownership of the means of production.

In all fairness, the Reagan administration faced an enormous political problem, just as future administrations will. The holy-war rhetoric of some environmental activists, perfected over the years, had fanned the flames of public outrage over "environmental atrocities" perpetrated by "greedy and uncaring corporations." A lot of waste and pollution is in fact generated each year, and much of it can be dangerous if not properly handled. The dangers currently faced are grossly overstated, however, and the cost of cleanup and prevention is scarcely borne by corporations alone.

Toward a More Fruitful Environmental Policy

The next administration would do a great deal of good for the nation if it reduced the enormous inefficiencies now plaguing U.S. environmental policy. The environment can be cleaner and safer, and we can expend far fewer resources in achieving this goal.

To strengthen the nation's protection against environmental threats, the next administration should take steps to expand local control and strengthen the liability approach. It could do this in several ways. First, the new administration should allow more leeway for the states and localities to make their own decisions about pollution control. Citizens are certainly in no mood to allow overly lax pollution control, yet jurisdictions choosing more rigorous control would quickly find the price their citizens were willing to pay. This time-honored variety of approaches among the states is an important part of American life, and is part of the genius of the federal system. In this system experiments are small rather than national in scope; more of them are tried; errors are much less costly; and the information produced is useful for the whole country.

Second, the new administration should focus federal resources on technical forensic assistance in tracing, or even finding ways to brand, pollutants as they are emitted, so that accountability could be enhanced. Polluters would more often be made to pay when harm is done, and innocent parties would less often be forced to pay in error. A careful firm storing chemical wastes, for example, would *want* to be able to show that its stored wastes did not show up where damage occurred, and it could if the wastes were branded.

Third, the next administration should assist states in reaching agreement on interstate compacts when important pollution damages are shown to be interstate matters.

For their part, states should seek to strengthen the common law through statute. Restoring the right of contract in the voluntary transfer of risk, for example, would help to revitalize the insurance industry, which historically has helped to "regulate" risks in cost-effective ways. Requirements for the posting of bonds would also strengthen the liability approach, for example, by insuring the solvency of a firm producing, processing, or storing hazardous wastes. Greatly lengthening the statute of limitations period for the recovery of damages in pollution cases might be another important measure. Branding chemicals that might escape into the water or air could be a real help. Many other innovations can also be tried at the state level without the need for national consensus or a national commitment.

The challenge in environmental policy is to develop better institutions—ones that will preserve environmental quality where it is most important, and minimize the constraints that would keep us from increasing wealth and prosperity. Only with more of the latter can our society better serve all our needs, including demands for safety and environmental quality.

The challenge in environmental policy is to develop better institutions—ones that will preserve environmental quality where it is most important, and minimize the constraints that would keep us from increasing wealth and prosperity.

Property rights should be expanded in ways which may seem novel in the United States today. If, for example, whales and commercially valuable fisheries in the oceans were owned, it is likely that ocean dumpers would avoid harming them. If that idea seems far-fetched, consider England and Scotland, where sports and commercial fishing rights are privately owned and transfer-

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able. Access is often rented daily or leased for longer terms, and prices vary from a few dollars per month for bait fishing to very high fees for the rarest and finest fly fishing. Long before the environmental movement took hold, owners of fishing rights successfully sued polluters of streams for damages and obtained injunctions against polluting activities. It worked: now they seldom have to go to court. Polluters generally leave those waters (and thus the fish) alone. When resources are owned, political wars are no longer necessary to protect them.

A great deal of education and some strong political leadership will be necessary if environmental policy is to be turned in a constructive direction. Unpopular things need to be said. The public must be persuaded of two fundamental facts. First, there is no widespread environmental crisis requiring action so urgent that scientific investigation should be bypassed. There is no evidence that we are in a national environmental crisis justifying emergency measures. Second, despite colorful rhetoric to the contrary, the risks of rapid technological change have been far outweighed by the benefits received. Cancer, for example, (apart from lung cancer attributable to smoking) is declining while life spans continue to rise. We are a far wealthier and thus far healthier and more resilient society than we would have been had technological change not been allowed, or indeed encouraged.

To reform environmental policy, the next administration will have to defeat the kind of sensationalist populism that arouses and sustains groundless fears about chemicals and other pollutants. The same sort of deliberate efforts being made by the press and the government to calm fears about AIDS (while at the same time providing information about the genuine risks posed) are needed to reduce the outrage that shapes environmental policies today. We can afford to buy much more environmental quality with a much smaller sacrifice of economic prosperity. □

"THAT DOES IT... SOMETHING'S GOT TO BE DONE ABOUT THAT HOLE IN THE OZONE!"

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Bank and Thrift Regulation

William S. Haraf

WHEN THE REAGAN ADMINISTRATION took office in January 1981, depository institutions were in trouble and their prospects were gloomy. Inflation and high interest rates had taken a tremendous toll among savings and loans, which were using deposits that paid double-digit rates to fund low-interest mortgages written years earlier. In June of that year Federal Home Loan Bank Board (FHLBB) Chairman Richard T. Pratt predicted that on average one savings and loan per day would hit zero net worth, and he acknowledged that one-third of the industry, with about $200 billion in assets, was not viable under the conditions at the time. In a "down-side," but not "wildly pessimistic," scenario, he estimated that the failure of these insolvent institutions could produce losses of $60 billion—an amount far greater than the reserves of the Federal Savings and Loan Insurance Corporation (FSLIC).

Commercial banks were also experiencing difficulties, although the industry as a whole was in better shape. The inflation of the 1970s had encouraged bank-financed speculation in agriculture, real estate, and commodities, especially oil. The disinflation of the 1980s meant that many of those gambles did not pay off, and banks were suffering the consequences. Bank failures and the Federal Deposit Insurance Corporation's (FDIC's) list of problem banks were beginning to grow rapidly.

Regulators were having difficulty dealing with the rising number of failures among depository institutions. Federal laws restricting interstate operations and cross-industry mergers were making it difficult for them to find buyers for failing institutions.

In addition financial innovations were taking business away from banks and thrifts. Money was streaming into unregulated money-market mutual funds. In 1980 Congress had passed the Depository Institutions Deregulation and Monetary Control Act to phase out interest rate ceilings on deposit accounts, but the new funds continued to gain ground. By the end of 1982 they held over $240 billion. The "securitization" phenomenon was beginning to take hold as well. The mortgage-backed securities market was starting to take off. Corporations were turning to the commercial paper market rather than to banks for their funding needs. And the large mutual fund families were attracting consumer savings.

The Reagan administration's diagnosis was that depository institutions had been overregulated and thus were unable to cope with the new world of volatile interest rates and rapid financial

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innovation. Early on, the administration made a commitment to deregulate depository institutions to enable them to compete in a changing marketplace. Secretary of the Treasury Donald T. Regan cited restrictions on commercial banks' securities activities, on interstate banking, and on savings-and-loan powers as areas where regulatory reform was needed. Lower interest rates and broader powers, according to Secretary Regan, would solve the industry's problems.

The administration was only partially right. Overregulation had contributed substantially to the industry's difficulties. But it was wrong to conclude that lower interest rates and deregulation would solve the problems of institutions that were already deeply in the red and had nothing to lose by gambling with what amounted to the taxpayer's money. When the next president takes office, the banking and thrift industries will still be troubled and their future prospects dim.

The administration was unable to achieve its goal of deregulating the banking and thrift industries. Only limited progress toward deregulation was made. Interest rate deregulation is now largely completed. Restrictions on interstate operations are gradually being phased out, mostly by the states themselves. And there has been some deregulation of bank and thrift powers as a result of actions by the courts, by the states, and by federal regulators in areas where they had discretion in interpreting existing law. But the administration was unable to get a broad deregulation bill through Congress. Substantial barriers to the integration of banking with other financial services remain.

Even more important from the standpoint of public policy, the savings-and-loan problem and the deeper problems with the management of the deposit insurance system have not been resolved. Indeed, the situation has deteriorated. Most private estimates of the cost of satisfying the claims of depositors in failed savings and loans now exceed Richard Pratt's 1981 estimate of $60 billion. In the meantime there have been dozens of outright bailouts of depository institutions—notable among them, Continental Bank's. There have been hundreds of bank and thrift failures in which large depositors and other creditors have been fully protected. And there are still hundreds, perhaps thousands, of shaky banks and thrifts in operation that could not survive without the federal deposit insurance sticker on their doors. Deposit insurance has become a much more intrusive presence in the financial system. As L. William Seidman, chairman of the FDIC, said in recent testimony before Congress, "The lender of last resort is no longer the Federal Reserve, but the federal deposit insurance system."

New Powers for Banks and Thrifts

The prospects for deregulating the banking and thrift industries originally looked quite good. The administration had an important ally in Senator Jake Garn, chairman of the Banking, Housing and Urban Affairs Committee. In late 1981, following extensive hearings, Senator Garn introduced a bill to grant banks and thrifts some new powers and to give regulators new tools for dealing with failing institutions. The bill took an initial swipe at the Glass-Steagall Act, the depression-era law separating commercial banking and securities activities, by allowing banks to underwrite municipal revenue bonds and to operate mutual funds. In addition Senator Garn laid out an ambitious agenda for 1982 that included further action on interstate branching and on securities, insurance, and real estate powers for banks and thrifts.

Despite the efforts of the administration and Senator Garn, however, the desirable goal of broad deregulation proved elusive. The pressing problems of the thrift industry held center stage in Congress throughout 1981 and 1982. House Banking, Finance and Urban Affairs Committee Chairman Fernand St Germain did not see broad new powers for banks and thrifts as contributing to a solution, and indeed, he was probably right. Moreover, the proposed deregulation of depository institutions encountered powerful opposition from a broad range of lobbying groups representing the securities, insurance, and real estate industries, and community banks. The 1982 Garn-St Germain Act authorized depository institutions to offer new deposit accounts and gave savings and loans some new lending and investment authority. It did not, however, grant depository institutions new securities, insurance, or real estate powers, which remained highly controversial.

The securities industry had opposed Senator Garn's 1981 bill on the grounds that implicit subsidies from deposit insurance gave depository institutions an unfair advantage in the securities business. There are some subtle issues involved in analyzing this assertion, and there was legiti-

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mate disagreement among economists over it. In an effort to save the bill, the administration proposed an innovative compromise that would have required banks to conduct their securities activities only in separately capitalized subsidiaries of a bank holding company. The approach offered several important advantages. It created a "level playing field" in the competition for providing financial services; it protected the deposit insurance funds from possible risks arising from deregulation; and it permitted regulation of the various holding company subsidiaries by function.

Insurance, securities, and retail companies were getting into banking without any role for the Fed as watchdog. The loophole seemed to threaten the whole structure of financial regulation.

This compromise turned out to be the model for the Reagan administration's first and only financial deregulation bill, and for virtually all subsequent deregulation proposals. The Financial Institutions Deregulation Act, introduced in 1983, would have allowed bank and thrift holding companies to use separately capitalized subsidiaries to engage in broad new securities, insurance, and real estate activities. Reform of interstate branching laws, however, was viewed as too controversial to tackle.

The debate over the administration's bill got caught up in a firestorm of controversy surrounding the so-called "nonbank bank" loophole—one of the most interesting and important market innovations of the Reagan years. According to the Bank Holding Company Act's definition, a bank took deposits and made commercial loans. A firm doing one or the other but not both was not a bank, so its parent was not a bank holding company. The nonbank banks themselves were regulated as if they were ordinary banks, but their parent companies were unregulated. Early in 1983 President Reagan's first comptroller of the currency, C. Tod Conover, began chartering nonbank banks for organizations like Merrill Lynch, Sears Roebuck, American Express, and John Hancock. Bank holding companies also obtained nonbank-bank charters to offer services across state lines.

The Federal Reserve System, which has primary responsibility for regulating bank holding companies, was horrified by this development. Insurance, securities, and retail companies were getting into banking without any role for the Fed as watchdog. The loophole seemed to threaten the whole structure of financial regulation. Federal Reserve Board Chairman Paul A. Volcker and Congressman St Germain became strong proponents of loophole closing. Indeed, their concern over the rapid pace of financial restructuring led them to advocate a moratorium freezing the financial marketplace as it stood in January 1983.

The nonbank-bank innovation presented an interesting dilemma for the Reagan administration. The administration acknowledged that nonbank banks were procompetitive and benefited consumers, but it also came to realize that this innovation rendered its carefully crafted, "comprehensive" legislation irrelevant without any apparent adverse side effects. The administration decided to support closing the nonbank-bank loophole only in the context of broader financial reform legislation.

But comprehensive legislation proved to be too controversial to get enacted. The Continental Bank bailout in July 1984 and the weakened condition of the banking and thrift industries were used effectively by opponents of deregulation. The Senate passed a much scaled-down version of the administration's bill in 1984, but the House did not go along. The melee over the nonbank-bank loophole led Comptroller Conover to impose a temporary moratorium on new charters for nonbank banks. Later, new charters were held up by court challenges.

A congressional stalemate lasted until 1987. By then the FSLIC was officially bankrupt, and congressional action was needed to deal with mounting thrift failures. The Competitive Equality Banking Act recapitalized the FSLIC, but it also—over the objections of the administration—closed the nonbank-bank loophole and imposed a one-year moratorium on new powers for bank holding companies. The expiration of the moratorium in March 1988 and an important court decision giving regulators flexibility in interpreting the Glass-Steagall Act led to a new round of congressional debate over bank holding company powers. In March the Senate passed an administration-backed bill that would remove many restrictions on the securities activities of bank holding companies. The House, however, did not act before adjourning.

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The Reagan administration's long support for deregulating bank holding companies did not produce any significant successes.

Deposit Insurance

Early on, the next administration will have to deal with the looming FSLIC crisis. The roots of this problem go back a long way. The savings and loan industry was insolvent on a market-value basis as early as 1971. By 1981, at the peak of interest rates, the problem approached catastrophic proportions. Professor Edward J. Kane, of Ohio State University's College of Business, estimated that the net worth of the savings-and-loan industry, after deducting unrealized losses on its mortgages, was $150 billion.

Congressional and regulatory action since then has been designed to shore up confidence in the deposit insurance system, to buy time for depository institutions to work their way out of problems, and to conserve the cash of the deposit insurance agencies.

In 1980 Congress increased the level of deposit insurance coverage from $40,000 to $100,000 to make it cheaper for depository institutions to raise cash. In 1982 it passed a resolution stating that the full faith and credit of the U.S. Treasury was behind the deposit insurance funds. With the Garn-St Germain Act, it allowed regulators to bolster a savings and loan's capital with "net-worth certificates," and it gave them authority to aid sick institutions with loans and other forms of assistance.

Regulators used the net-worth certificates and other accounting gimmicks to make it appear that savings and loans had more capital than they did. The regulators lowered minimum capital standards and encouraged institutions to grow their way out of problems. These policies played into the hands of the industry's plungers and speculators. As a result, the moral-hazard problem long associated with deposit insurance became much more serious. The industry's difficulties with its portfolio of low-interest mortgages peaked in 1981. But serious credit quality problems emerged in the mid-1980s as insolvent and nearly insolvent savings and loans adopted high-risk strategies to try to recoup their losses.

Many people blame deregulation, particularly at the state level, for the depth of the current savings-and-loan problem. But deregulation in Texas, California, and Florida took place after many of the savings and loans in those states were already economically insolvent. Managers of bankrupt savings and loans had nothing to lose by taking high-risk gambles to try to recoup their earlier losses.

Throughout this period the banking industry and the FDIC have been in better shape than the savings and loans and the FSLIC, although not without substantial problems of their own. Capital regulation and failure management by bank regulators have generally been more disciplined than by savings-and-loan regulators. Problems have been addressed more quickly. But in some respects bank regulation has been on the same slippery slope. Bank regulators established a capital forbearance program in 1986 to permit weakened farm and energy banks to operate with substandard capital. In addition banks have long been beneficiaries of informal forbearance. Regulators have not required shaky banks to write down the value of bad loans. Indeed, they sometimes have discouraged banks from doing so on the grounds that it would shake confidence. When failures have occurred, the FDIC has resorted to techniques that protected deposits in excess of legally insured amounts and protected other bank creditors who were not legally insured. Sometimes creditors and shareholders of a failing bank's holding company have received significant protection as well. As a result, the normal disciplines of a competitive market on excessive risk-taking have been short-circuited.

The Reagan administration was the first to undertake a comprehensive study of deposit insurance in order to find ways to place it on sounder footing. The Cabinet Council on Economic Affairs issued a report in 1985 recommending risk-related deposit insurance premiums, significantly higher capital requirements, stronger disclosure requirements, and tougher examination and supervision of depository institutions. The interagency Task Group on Regulation of Financial Services, chaired by Vice President George Bush, was established primarily to develop a plan to consolidate and rationalize the responsibilities of federal financial regulatory agencies, but it also recommended deposit insurance reforms. The task group issued recommendations that were similar in most respects to those of the cabinet council, but it went one step further by advocating an end to the protection of uninsured deposits of failed banks and thrifts.

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Reforms along these lines could have substantially improved the operation of the deposit insurance system, provided they were properly implemented and strictly enforced. But they were never adopted. The administration and Congress first had to come to grips with the hundreds of insolvent and nearly insolvent depository institutions that had no hope of operating in a more disciplined environment. The FSLIC's resources were far from adequate for the task, and in 1985 there was no interest in providing it with additional resources. The unwillingness to get insolvent savings and loans out of the market prevented needed reforms that could have placed the system on a sounder footing.

When the FSLIC was finally recapitalized in 1987, the funds Congress made available were far less than what was needed and what the administration had requested. Problems deepened at the FSLIC and, to a lesser extent, at the FDIC as a result of widespread problems among Texas banks. The agencies, out of necessity, have increasingly resorted to mechanisms to reduce their out-of-pocket cost of managing failures. They have given acquirers of failing institutions assistance packages that include subsidized financing and guarantees against losses from bad loans and changes in interest rates. They have granted special exceptions on capital standards and accounting rules. They selectively have granted powers not available to healthy competitors. They have permitted very shaky banks and thrifts to bid for failing institutions. And they have increased their use of direct assistance, that is, outright bailouts of ailing banks and savings and loans.

The next administration will have to confront the negative consequences of these policies. First, through the accumulation of common and preferred shares, loans, and loan guarantees in these deals, the deposit insurance agencies are bearing a great deal of risk that is likely to result in sizable future outlays. Problems have not been resolved; they have been postponed. Second, these policies have exacerbated moral-hazard problems. In some cases a very large share of a reorganized savings and loan's or bank's capital belongs to a deposit insurance agency. The

"I hope you're not withdrawing, sir. We're a little short of cash."

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private owners can be leveraged in the extreme, and may have the same incentives to "go for broke" that led to the current problem. Third, these policies have worked to the disadvantage of healthy firms, which must compete against resurrected or reorganized competitors that have been granted special regulatory advantages. Thus their own capital and profitability have been placed in jeopardy.

Lessons for the Next Administration

The problems of the thrift industry directly and indirectly had an enormous influence over the financial regulation agenda during the Reagan years. The administration was correct in concluding that deregulation was critical to the survival of the banking and thrift industries. It was a fatal mistake, however, to believe that deregulation would solve the problems of firms that were already economically insolvent. In 1981 few appreciated the potential adverse consequences of deregulating an industry that was deeply in the red and had nothing to lose. The reluctance of Congress and the administration to deal with weaknesses in the system prevented action on the broader financial restructuring issues that were the administration's first priority.

The next administration will have to take strong action to clean up the deposit insurance mess and to ensure that it never happens again. Restoring a financial system that is less dependent on government guarantees and more dependent on private capital will require more than simply closing down insolvent institutions. It will require adequately capitalized survivors operating with appropriate incentives. Getting there will not be easy or cheap.

Many economically viable banks and thrifts will need to raise capital over the coming years, but their ability to do so is severely hampered in the current environment. Hundreds of insolvent and nearly insolvent thrifts are still in the market, bidding up deposit rates and taking gambles with taxpayers' money. Scores of resurrected banks and thrifts are operating with special advantages granted by regulators. It is no wonder that managers of healthy institutions find raising capital difficult and without reward.

The first step in turning this situation around is for Congress to enact legislation granting the FSLIC resources sufficient to get insolvent institutions out of the market as expeditiously as possible without resorting to methods that distort incentives and reduce the competitiveness of healthy institutions. Inevitably much of the cost will fall on taxpayers. Some will say that Congress should resist an industry bailout. But bleeding the healthy part of the industry dry is not in the public interest. Moreover, a fair share of the responsibility for the present situation lies in Washington, where regulators have mismanaged depository institutions for decades.

A credible plan must then be instituted to ensure that the mistakes of the past are not repeated. Economists have offered a variety of proposals for improving private incentives in the deposit insurance system under the assumption that, for better or for worse, it is here to stay. Some economists have advocated risk-based deposit insurance premiums. This approach would substantially improve the incentives facing depository institutions, provided that premiums reflect actual differences in risk. It is doubtful, however, that an effective system could be implemented by a federal agency. Other economists have advocated "narrow banking." This would require banks to invest only in perfectly safe assets and spin off all other activities, such as commercial lending, into separately capitalized uninsured affiliates. While this approach could solve the deposit insurance problem, it also has economic costs: it reduces economies of scope in banking. For centuries commercial banks around the world have combined deposit taking and commercial lending without the systemic problems we have today. These problems are the result of gross mismanagement of federal guarantees. They are the not the result of combining deposit taking and commercial lending in the same entity.

Many economically viable banks and thrifts will need to raise capital over the coming years, but their ability to do so is severely hampered in the current environment.

Three steps can restore discipline to the nation's deposit insurance system. First, violations of capital standards should involve early and *automatic* penalties, including fines and restrictions on dividends, growth, and acquisitions.

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Capital adequacy regulation today does not involve serious penalties. An institution whose capital is below required levels must merely devise a plan for bringing it back up over time. Imposing penalties at an early stage will encourage institutions to manage capital more carefully, take corrective actions sooner, and seek a merger partner before the deposit insurance agencies have to get involved. Second, if owners are unwilling to recapitalize a failing bank or thrift, regulators should have authority to take control before the institution's capital runs out. There are mechanisms for doing this without violating due process for owners. Third, the policy of protecting large depositors and other creditors must stop. Protecting the stability of the financial system does not require protecting all the liabilities of depository institutions. The regulatory agencies have the tools to expose large depositors and other creditors to losses when a failure occurs, while preserving the liquidity of deposit accounts. They can safely apply those tools to banks and to savings and loans of all sizes.

In sum, moral hazard from deposit insurance is manageable with a strong commitment to capital adequacy regulation, prompt action when insolvency occurs, and the restoration of market disciplines that have eroded under current federal failure-management practices. The most important lesson of the savings-and-loan experience is that forbearance on capital standards and insolvency determination is a prescription for disaster. Had capital regulations and limits on deposit insurance coverage been strictly enforced, savings and loans simply could not have gone for broke the way they did. Owners and depositors would have pulled the plug on their own a long time ago.

Finally, there are important reasons for the next administration to continue the Reagan administration's efforts to deregulate bank holding companies, and a tactical lesson to be learned from its experience as well. The administration never crafted a balanced approach to eliminating entry barriers in the financial services industry. Under the premise that the survival of depository institutions was threatened by overregulation, the administration's 1983 bill offered new powers to bank and thrift holding companies. But nonbanking firms were not granted symmetric entry into banking. The legislation was correctly perceived by securities, insurance, and real estate industry groups as one-sided, allowing banks to encroach on their businesses. Their lobbyists lined up to oppose it. The lesson that should be learned is that if it is to have any chance of passage, legislation proposing holding company deregulation must offer a "two-way street." Bank holding companies should be granted broader powers, but outside firms should be able to acquire banks. None of the Reagan era proposals—the administration's 1983 bill, the 1984 Garn bill, or the 1988 Proxmire bill—offered meaningful opportunities for nonbank firms to acquire banks.

With proper safeguards, the deregulation of bank and thrift holding companies offers prospects for substantial public benefits, not the least of which is the attraction of much needed capital to the industry. In that sense a "two-way street" can be part of a comprehensive solution to the deposit insurance problem.

In addition, there are important changes in international banking markets on the horizon that will make bank holding company deregulation in the United States important for the international competitiveness of U.S. financial services companies. As part of its "1992" project for the full integration of European markets, the European Community has proposed offering a "common bank license," which would enable any banking institution in Europe to engage in a wide range of financial activities throughout Europe, as long as it is permitted to do so at home. If this proposal is adopted, competitive pressures will almost surely push all European nations in the direction of adopting "universal banking systems," in which a broad range of financial services is provided within the same entity. The result is that U.S. financial services firms will increasingly find themselves competing in international markets against large, fully integrated institutions. The ability of U.S. firms to compete effectively could well be adversely affected by laws restricting the range of services they can offer.

Removing domestic restrictions on bank and thrift ownership and affiliations will increase competition, improve the ability of the U.S. financial system to adapt to change, and provide opportunities for synergies from the joint production and marketing of financial services. The enormous improvements in information technologies in recent years have probably increased the advantages of allowing financial institutions to offer multiple services over broader geographic areas. Giving them the authority to do so will lead to a more efficient financial system, one better able to provide quality financial services at attractive prices to both domestic and foreign users of financial services. □

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Transportation Policy

Thomas Gale Moore

OUR ECONOMIC SYSTEM is built on the transportation of goods, services, and people. The fact that transportation represents 3.3 percent of our national income understates the vital importance of that sector to our economy and our well-being. All trade includes the movement of products, services, or labor. A good case could be made for the proposition that had transportation not improved significantly over the last 200 years, our economy would still be relatively primitive and our standard of living much lower.

Improvements in transportation widen and deepen markets. Whereas in the nineteenth century each town of any size had its own shoe factory, ironmonger, and beer brewer, today large automated plants service major portions of the country from a single location. Without improvements in transportation, such gains in economies of scale would have been impossible. Oranges were expensive luxuries 100 years ago; fruits and vegetables were only available from local sources and thus unavailable most of the year.

Since the founding of the first states, governments have assumed a major role in providing for transportation. Today our government builds, subsidizes, and regulates much of the infrastructure on which transportation relies. This article addresses the role of the federal government in financing and regulating transportation—including the airline, trucking, railroad, pipeline, and shipping industries—and presents a set of desirable reforms in transportation policy.

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The Role of Government

There are several economic rationales given for a significant government role in the transportation industries. None of these, however, comes close to being a universal truth. Studies in recent years have found that only rarely do the economics of transportation justify the degree of government intervention that we observe.

Traffic Management. A fair portion of government regulation of transportation simply provides for the smooth flow of traffic. Devices like stop lights and lane markings are supplemented with extensive regulations that set forth the rules of the road: drive on the right, pass on the left, yield right-of-way, and so forth. The Federal Aviation Administration (FAA) issues such rules

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for air traffic; the Coast Guard does the same for shipping traffic. While traffic-management rules are often presented as safety measures, they are more than that: they minimize interference among users in order to make the most efficient use of the physical infrastructure. They are needed in every mode of transportation.

Infrastructure. The government has an important role in providing the infrastructure for transportation as well as in managing traffic. While it is possible to have the infrastructure furnished by the private sector various levels of government have traditionally financed, at least in part, the basic investments in transportation facilities. Private toll roads, for example, have been built and are under consideration in some parts of the United States, yet for many highways charging explicit tolls would increase user costs significantly. Even ignoring the increased congestion that a toll booth would create, the cost of manning and collecting the tolls would be horrendous. The technology, however, has been recently developed that would permit an inexpensive monitoring of traffic that could significantly reduce highway congestion at peak hours. Nevertheless, virtually all highways, roads, and city streets are built by governments, often using funds raised from fuel taxes.

For similar reasons governments have usually funded harbor projects, river dredging, and canal building. (Governments also fund such projects because they are politically attractive local projects.) With the exception of canal building, which has involved some significant private efforts in the past, almost all financing is public—usually through the federal government. For less obvious reasons governments have been the chief owners, builders, and operators of airports used by commercial aviation. Private airports once serviced commercial aviation and do service general aviation, but currently within the United States all commercial airports are owned or operated by local authorities.

The railroad industry is the only major form of transportation responsible for its own infrastructure. The distinction may be misleading, however. The construction of railroads in the nineteenth century was so heavily subsidized that the system was overbuilt to the point that rail rates did not adequately cover capital costs. As a consequence the railroad industry has been either marginally profitable or unprofitable for most of its history, with periodic waves of bankruptcies.

A major factor accounting for government involvement in transportation infrastructure is the necessity of providing rights-of-way. Through eminent domain the state has the legal right to acquire property for public use; it is considerably more costly for a private firm or individual to purchase rights-of-way. Most railroads were built through grants of public land and therefore never faced the right-of-way problem. Since rivers and harbors in the United States are not privately owned, private provision of water infrastructure is uneconomical.

Regulation

Economic regulation of the transportation industries in this country is 101 years old. In 1887 the Interstate Commerce Commission was created to regulate railroad rates. Initially ICC supervision was intended to reduce the monopoly power of railroads over certain traffic from small towns. The railroads supported regulation to reduce pressures to lower rates in highly competitive markets. With the advent of motor vehicles in the early part of the twentieth century, regulation was extended, first by states and ultimately by the federal government, to motor carriers. This extension of regulation to an inherently competitive sector was designed to protect the profits and business of the railroad industry. Subsequently water carriers, air freight, and air passenger transportation were brought under federal control.

Each of these industries was subject to restrictions on rates, entry, exit, and profits. The result turned out to be massively inefficient.

Each of these industries was subject to restrictions on rates, entry, exit, and profits. The result turned out to be massively inefficient. Costs were inflated, routing was inappropriate, rates were excessive, and yet the firms often failed to earn the profits that would be expected in a cartelized environment. Some of the "benefits" of regulation were siphoned off to organized labor. Some were simply wasted in nonprice competition or in inefficient rules and, at least for trucking

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firms, some were capitalized into the value of the operating certificates granted by the ICC.

As the inefficiencies were recognized, pressure grew to deregulate these industries. In fact, as part of a worldwide movement toward freer markets, deregulation has become an important idea, not only within the United States but also in Europe and Asia—even in non-market countries. In the United States this has taken the form of eliminating economic regulation of the airline industry (including air freight) and significantly reducing regulation of motor carriers, buses, and railroads. The results have been excellent.

Issues in the 1980s

Airlines. Among the industries granted new freedoms in the late 1970s, the airline industry has been the most thoroughly examined. Study after study has documented the benefits that passengers have received from the removal of most controls in 1978 and the elimination of the Civil Aeronautics Board in 1982. A 1986 Brookings Institution study by Clifford Winston and Stephen Morrison concluded that airline passengers gained about $11.5 billion annually (in 1988 dollars) from deregulation. Deregulation has permitted airlines to become more efficient. Load factors have improved; more passengers are carried on typical long-haul flights. The result is that airlines are able to charge less and be as profitable as they were under regulation.

Safety, which has steadily improved since the advent of commercial aviation, has continued to advance. Comparing accident figures eight years prior to deregulation and eight years following it, for example, it can be seen that the number of accidents has fallen by nearly one-third and the number of fatalities per 100,000 flight hours by one-half.

The airline industry has expanded since deregulation. Employment grew by more than one-third from 1977 to 1986. Wages of airline workers appear to have kept up with wages in the rest of the economy over this period. And, contrary to the fears of many, air service to small communities has grown rather than contracted.

Alongside employment growth in the industry, productivity has increased sharply. On the long-haul routes airlines are utilizing larger aircraft with more seats. The hub-and-spoke system has led to a more efficient use of both planes and personnel. Overall, airlines increased their productivity by 7 percent from 1976 to 1983, in spite of the sharp increase in fuel prices. Over the same period, non-U.S. carriers suffered about a 40 percent *reduction* in productivity.

Studies indicate that airline profits have been helped by deregulation. If gains to passengers are added to the airlines' increased profits, the total benefit from airline deregulation is about $15 billion per year.

Railroads. Deregulation of the railroad industry has provided large benefits to shippers as well as to the railroads themselves. The Staggers Act, passed in 1980, freed nearly two-thirds of the railroads' traffic from government supervision. The industry has been granted more freedom to abandon unprofitable routes and to merge weak railroads. As a consequence rail shipping costs as measured by revenue per ton-mile, which had remained virtually constant in real terms from 1970 to 1981, fell nearly 20 percent in real terms over the following four years. Although not all commodities have enjoyed lower rail rates, Federal Railroad Administration rate indices show declines for farm products, chemicals, primary metals, and transportation equipment between 1980 and 1985. And while the coal industry has complained that railroads have increased charges, at least in some uncompetitive markets, the average revenue per ton for coal shipments has been approximately constant since partial deregulation.

Railroad workers have been able to maintain their wage rates but have faced a considerable contraction in employment. Annual compensation for employees of the major railroads rose 20 percent in real terms in the decade of the 1970s, and continued to escalate at about the same rate for the next five years. Under the new freedom given the railroads by the Staggers Act, the high cost of labor led to a one-third cut in employment in the five years from 1980 to 1985. The net result was a sharp increase in labor productivity, as the railroads continued to carry as much freight with less labor.

Trucking. In 1980 Congress also partially deregulated the motor carrier industry. Shippers have benefited strongly from this legislation. Revenue per ton for truckloads, an indicator of shipping rates, fell 22 percent from 1979-1980 to 1986, and revenue per ton for less-than-truckload shipments declined 6 percent from 1983 to 1986.

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A survey of shippers indicates that service quality has improved on average as well. In seven major dimensions the shippers rated the less regulated service as better than or as good as the service prior to partial deregulation. Studies done for the Department of Transportation show that service to small communities has been maintained or even improved since trucking firms were given more freedom.

Two groups lost from trucking deregulation: the owners of the certificates of public convenience and necessity, and the members of the Teamsters Union. Both had profited significantly from the suppression of competition under ICC regulation. The ICC grants of operating authority were bought and sold for hundreds of thousands or even millions of dollars, reflecting the value of the monopoly franchise. Truck drivers and their helpers earned wages that I estimated, in 1978, to be 50 percent above the competitive level.

With the advent of partial deregulation and the ICC's liberal policies in granting new certificates of public convenience and necessity came a surge of entrants: the number of firms with operating rights has almost doubled. Consequently, the value of the operating rights has fallen to close to zero.

In addition many of the new entrants have not been unionized, which has put considerable competitive pressure on existing trucking firms to reduce their labor costs. With nonunion wages typically 25 to 35 percent below teamster wages, the percent of motor carrier workers that were unionized fell from around 60 percent in the late 1970s to 28 percent by 1985. Moreover, union contract wages, which had increased 20 percent in real terms in the 1970s, fell 12 percent in the five years after the 1980 act. In a 1987 study published in the *Journal of Political Economy*, Professor Nancy L. Rose of MIT's Sloan School of Management calculated that the aggregate wage loss was between $990 million and $1.8 billion (in 1986 dollars).

Oil and Gas Pipelines. Oil pipelines have been regulated since the early 1900s when the Standard Oil Company was accused of using them to consolidate market power over production and retail markets. Fortunately entry and exit from the business have never been regulated. As a result, competition has coexisted with regulation and prevented the misallocation of resources caused by regulation in other industries. Individual oil producers or refiners who might have been captive shippers bought into the pipeline system to ensure access to this vital transportation link. Transportation of oil by ship, barge, and truck provided competitive alternatives in the majority of markets.

Recent court cases have put pressure on the Federal Energy Regulatory Commission (FERC) to regulate oil pipeline rates more strictly. An investigation by the Antitrust Division of the U.S. Department of Justice, however, found few examples of harmful market power. The Reagan administration has proposed deregulating most oil pipelines and keeping a simple price cap on the remainder.

Two groups lost from trucking deregulation: the owners of the certificates of public convenience and necessity, and the members of the Teamsters Union.

Unlike oil, natural gas cannot be transported economically by water or by truck, so natural monopolies in the pipeline network may be more common for gas than for oil. Since 1954 when the U.S. Supreme Court ruled in *Phillips Petroleum Company* v. *Wisconsin* that wellhead prices needed to be controlled, the regulation of rates for gas pipelines has been tangled with the regulation of gas itself. In the last 10 years some progress has been made in deregulating gas. At the same time FERC has been looking for ways to bring more competition to bear on gas transportation.

Maritime Shipping. National security is a common rationale used for providing subsidies to the merchant marine. However, there is little economic reason for government involvement. The subsidy takes two forms: The Jones Act requires that all domestic shipping use U.S. ships with U.S. crews. Because of this requirement, rates are elevated well above competitive levels. In addition the federal government has provided construction subsidies for U.S. flagged ships engaged in foreign trade. Ships which receive the construction subsidies, however, are not permitted to engage in domestic trade. The Reagan administration has allowed some ships to repay this construction subsidy, thus recovering the cash and improving competitive conditions in domestic trade at the same time. Nevertheless,

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the whole industry remains inefficient and expensive both for shippers and for taxpayers.

Issues for the 1990s

Probably the most important issues for the 1990s deal with ensuring an appropriate infrastructure for airways, maintaining and extending the deregulation of surface transportation and airlines, and finding a workable and more limited system for regulating oil and gas pipelines.

Infrastructure. The aspect of air travel that has received the most criticism since deregulation is congestion and delays. Part of the problem was the 1981 air-traffic controllers' strike and their subsequent firing just at the time air travel was growing rapidly after deregulation. It took several years for the FAA to rebuild its staff; even today there are fewer controllers than before the strike.

Airline deregulation contributed strongly to growth in air travel. As a result airports, aircraft, and airspace have become more congested. Inevitably this has led to more delays and a perception that safety is eroding. Numerous studies have looked at the safety question, and failed to find any harm to safety from deregulation or the growth in traffic. Yet the congestion is real. Certainly the number of passengers per plane has gone up. Moreover, the growth of the hub-and-spoke system, and the need to transfer passengers within a short time period from one flight to another, has led to airports that at peak times rival the streets of Manhattan during lunch hour.

Quick, easy, and cheap air travel also has led to considerable peaking problems in the airline industry. Business people prefer to take short flights first thing in the morning and longer flights late in the afternoon. A great many business flights are one-day round trips. Rush-hour traffic leads to congestion everywhere, including in the sky. But this congestion is not always inefficient. To eliminate rush-hour delays and congestion on our highways would require the construction of a considerably larger road system, one that would remain virtually unused much of the time. The same is true for airways. To eliminate all congestion at airports, in aircraft, and in the airways would be costly and inefficient. It would require the construction of considerable excess capacity that would be idle much of the time.

Congestion can result from inadequate capacity or, more important, from the inefficient utilization of existing capacity. In the case of air travel and highway transportation, there is no mechanism to allocate usage to non-peak times except the queue. That is, only if congestion and delays become so costly to users that they voluntarily shift to the non-peak period is there any rationing of scarce peak facilities.

For air travel, however, it is far easier to adopt a price system for rationing capacity. Two elements of air travel are underpriced: the FAA does not charge directly for the use of its services, nor does it charge different prices for peak and off-peak periods. Airports do charge landing fees but, in the main, these tariffs are low and invariant with time. A few airports do impose a surcharge for peak use, but even in these cases the surcharge is small.

The FAA collects a ticket tax that is considered to be a user fee and that is deposited in the Airport and Airway Trust Fund. Since this tax is collected from all passengers as a percentage of the price of their ticket, it is unrelated to time of use or costs imposed on the air system. Thus the FAA charges nothing directly for the use of the air-traffic control system no matter how congested it is. If the system cannot handle more traffic at peak periods, the expectation is that the FAA will spend the funds to expand capacity.

In a more rational system the FAA would charge for use of the air-traffic control system. This simple change would reduce use by general aviation. Many pilots of small planes would elect to utilize small private or municipal airports that do not offer FAA-manned towers. Moreover, charging premiums for use of the system during congested times would shift some commercial or general aviation flights to other, less crowded periods. Not only would this save resources, but also it would make the system safer by reducing congestion.

A good method of introducing rational pricing in the air-traffic control system would be to shift this system from the public sector into the private sector. In some parts of the world private companies operate air-traffic control towers, as they have in the United States in the past and do at a number of smaller airports even today. A useful first step might be to allow airports to opt out of the FAA tower system and trust fund, and in return receive a portion of the ticket tax generated at that airport. The airport would be free to charge for the use of the tower and would

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be responsible for constructing and maintaining its own landing facilities. The airport would hire its own air-traffic controllers and provide its own control equipment.

Such an approach would naturally lead to a more rational scheme of landing fees. At most airports landing fees are ridiculously low. For example, a small plane can land at Washington's National Airport during the peak morning hours for $6—less than it costs to park a car for the day. Some airports, like those under the jurisdiction of the New York Port Authority, have experimented with surcharges for peak periods with good results. Even in these cases, however, surcharges are comparatively low and do little to affect commercial aviation scheduling decisions.

Extending and Maintaining Deregulation

There are considerable pressures to reverse, at least in part, some of deregulation's successes. Coal companies, power producers, and grain shippers have lobbied to limit rail price increases for "captive shippers." Such shippers are those that have no good alternative for moving their goods by other than a single railroad. Under the Staggers Act, the ICC is charged with interpreting and defining "captive shippers." A number of these bulk commodity shippers claim that the ICC has failed to protect them from a railroad monopoly.

Actually, the issue revolves around which business interest is going to keep any high earnings derived from favorable location or special factors of production. For instance, if a coal company, either because of its location or because of the quality of its coal, is in a position to earn profits in excess of a normal return on its investment, a monopoly carrier could charge so much that the coal mine earned only a normal profit while the railroad kept the extra revenue. From an outsider's point of view there would be little reason to favor the stockholders of the coal firm over the stockholders of the railroad company. If a railroad does charge excessively, this simply induces the shipper to search for alternatives.

It is also worth keeping in mind that the railroads have been financially weak for decades. Only with the advent of the Staggers Act has the industry moved away from bankruptcy. Tinkering with the Staggers Act therefore should be avoided.

While there are no visible efforts now underway to rewrite the Motor Carrier Act, there is a danger that with pro-regulatory commissioners the policies currently being followed on entry and pricing might be reversed. Reregulation could be reimposed by the ICC on its own. Consequently, it is important that the next administration work to remove the remaining controls on trucking. Currently these controls only add to the paper work and serve no useful function. Occasionally the commission forces a trucking firm that gives a discount to a shipper to recapture the discount, a result that increases uncertainty and reduces competition. There is no economic justification for continued regulation of this inherently competitive industry.

Reregulation of the airline industry is also a possibility that must be opposed vigorously. The greatest danger is that the FAA will be given more power to control landing slots at airports and be induced to use such power to limit entry into particular markets. Once entry is limited, price will naturally have to be controlled to protect consumers. Thus it is imperative that the FAA's control over landing slots, which is now exercised in a few congested markets, be limited or eliminated. Placing restrictions on the number of take-offs and landings would be a move in precisely the wrong direction.

The guiding principle for the next administration in transportation policy should be to foster market forces.

Legislative action is needed to deregulate oil pipelines, and a bill to deregulate natural gas should also liberalize the regulation of gas pipelines. Absent legislative action, FERC should be encouraged to continue its experiments with greater competition in the industries it regulates.

Conclusion

The guiding principle for the next administration in transportation policy should be to foster market forces. Economic regulation should be limited or eliminated. More use of the market will provide gains to users of the transportation system and to our economy, while protecting the gains already achieved through deregulation. □

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Readings

Massachusetts Miracle

The Massachusetts Miracle,
edited by David R. Lampe
(MIT Press, 1988), 367pp.

The New Economic Role of American States,
edited by R. Scott Fosler
(Oxford University Press, 1988), 384 pp.

Reviewed by Lawrence B. Lindsey

From the time of the first king who called himself "The Great" when good weather produced a bountiful harvest, politicians have found it useful to exaggerate the benefits of their tenure in office. At the same time, the historical role of economists and other social scientists has been to put these political claims into perspective.

The 1988 presidential campaign saw the addition of the "Massachusetts Miracle" to the millennia-old record of political hyperbole. There is no question that economic conditions are very good in Massachusetts. At issue is the extent to which state government policies helped create those conditions and the extent to which those policies would work if applied to the nation as a whole.

Economists have never taken readily to claims of miracles in the realm of economic phenomena. We do not believe that economic growth is something that results from the incantations of politicians or bureaucrats, no matter how fervent their faith. Governments can stand in the way of economic growth by adopting the wrong policies. But when things go well because politicians have failed to interfere with economic growth, only the most cynical among us would term it a "miracle." In Massachusetts the miracle is alleged to result from political intervention in the economy and not from political benign neglect.

Lawrence B. Lindsey is professor of economics at Harvard University.

Skepticism about politically induced economic miracles is even more appropriate when considering the activities of states and localities than nations as a whole. States lack the fiscal and monetary tools that central governments possess. In addition any extra stimulus injected into their jurisdictions can easily flow across borders to other states. The most significant contribution that governors can make to their state economies is, in a sense, a negative one: They can end state-imposed restrictions on growth and let the market economy take care of itself.

This view is shared even by economists who tend to favor more government intervention. For example, in *The Massachusetts Miracle* Lester Thurow writes:

> Economic miracles, like instant stardom, don't really occur.... Economic success may suddenly become visible, but such miracles are almost always produced by solid fundamentals and these solid fundamentals always have a long history.... All too often in history a region has had a real comparative advantage in some type of production and found ways to throw that comparative advantage away. Massachusetts did not do so, and that is to the credit of the citizens who lived there and to the leaders, public and private, who lead them.

Hard economic analysis is, therefore, unlikely to provide any support for the political claims regarding the Massachusetts economy.

Left to the soft analysis of the goodness of intentions, the idea that a miracle has occurred will survive and grow in the public's mind. Subjected to the hard rigors of statistical analysis, the claimed miracle will wither. The "miracle" survives only at the sufferance of the analyst.

The Massachusetts Miracle, edited by David Lampe, is a mixture of hard and soft treatments. Much of the book is a compilation of speeches by politicians claiming that their policies will fix the economic problems of the Commonwealth.

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This is soft analysis at its softest. The recipe is simple: Say things have never been worse; assert that they got that way because of the policies of your predecessors; lay out a policy that you call "comprehensive"; hope things improve; then claim credit for your success.

For example, the book reprints two 1972 speeches given by Governor Francis Sargent, and 21 pages of excerpts from "An Economic Development Program for Massachusetts"—a 70-page document published by the Dukakis administration in 1976, his second year as governor. Devotees of political rhetoric may find these enjoyable. The 1972 speeches are typical of Sargent, who was known for his short, declarative style. "Let's look at the facts" was a favorite. Similarly, the 1976 piece is classic Dukakis. Start with a goal: "More jobs and higher incomes for the residents and businesses of the Commonwealth." Follow it with headings labelled "priorities" such as transportation, energy, capital, and labor. (Very few things aren't priorities.) Under each priority set out a number of "next steps" usually beginning with verbs such as "provide," "appoint," "prepare," "submit," and "complete." A sufficiently comprehensive list of priorities, each with its own next steps, can easily be stretched to 70 pages. But while this may be helpful to those interested in the Dukakis administrative style, you will not find the reasons for the Massachusetts miracle here. Even the book concedes that the plan "ultimately led to little specific action."

A small step up on the rigor scale is provided by the series of seven articles written by economists at the First National Bank of Boston, who are clearly very talented but are constrained to appeal to the mass market. The best article in this series, by Lynn Browne, analyzes the effect of technological change on the business services industry. Browne concludes that state policies, which focused on manufacturing, entirely missed business services, a vitally important industry that contributed much to the growth of the state.

The articles in the final group—analytically the strongest—were written by analysts of particular industries. Like Lynn Browne's piece on business services, each tells us of a particular success, but does not give the reasons why the Massachusetts economy as a whole prospered. One of the best, by Nancy Dorfman of MIT, looks at the belt of high technology industries around Route 128. Dorfman concludes that the high-tech boom did not emerge from any effort by state or local governments to attract firms. Rather, the area's universities and existing high-tech industries provided good reason for new firms to locate nearby, a phenomenon that Dorfman calls "agglomeration externalities."

Other detailed pieces look at the importance of small businesses, higher education, and the defense boom. These articles succeed in finding reasons why the sectors they discuss did well; in no case is intervention by state authorities given as a reason. The reader is left with a list of particular reasons for the success of particular sectors, but no overview on how these sectors fit into the state's overall growth. The reader is forced to put the pieces together himself.

The Massachusetts Miracle therefore presents an apparent paradox. The only articles that address the overall performance of the state are the nonanalytic claims of the politicians and their critics in the business community. The analytic articles, on the other hand, indicate that these political issues have nothing to do with the result. The editor is left to conclude that although a remarkable turnaround did occur, "no individual or organization from business, academe, or government can claim credit for consciously engineering this development. It happened by itself, fostered by a remarkable combination of favorable conditions that emerged from the particular culture of the region and by chance."

The New Economic Role of American States, edited by R. Scott Fosler, begins its seven-state analysis with a look at Massachusetts and its economic development policies. Fosler could not have selected better authors for the Massachusetts study. Ronald Ferguson, assistant professor at Harvard's Kennedy School of Government, and Helen Ladd, professor at Duke University's Institute of Policy Sciences and Public Affairs, have outstanding academic records of research into the economics of state and local governments, and of Massachusetts in particular.

Given the potential for a hard analysis of the "miracle," the Ferguson and Ladd piece is somewhat disappointing. It does have a number of interesting and important sections, however. They provide an interesting short history of the Massachusetts economy dating back to the industrial revolution. Their text is also much better than *The Massachusetts Miracle* in detailing the economic development strategies actually tried by Massachusetts.

The litany of agencies involved in economic development is instructive by itself. For example, the Wednesday Morning Breakfast Group (WMBG)

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worked closely with the Centers for Community Economic Development (CCED), which in turn created Community Development Corporations (CDCs) as well as a Community Development Finance Corporation (CDFC). At one point, the authors discuss the role of the WMBG, coupled with the CDFC and pressured by the CDCs, in creating the Massachusetts Industrial Mortgage Insurance Agency (MIMIA).

While students of bureaucracy will find these details interesting, most readers will find their eyes glazing over at the alphabet soup. But there is an important point in the alphabet soup that readers should be careful not to miss. These agencies and pressure groups are exactly what an activist economic development policy is all about. Each agency must be created, its members appointed, and its activities funded. The 70-page Dukakis "Economic Development Program for Massachusetts" was the blueprint behind this bureaucracy.

The bias of the authors seems to be that these agencies matter. Fully 15 pages are devoted to the bureaucratic proliferation of the first Dukakis administration, but less than 4 pages are given to the King administration that followed. One of King's first acts was to abolish the Dukakis-created Office of State Planning. Apparently the destruction of a bureaucracy makes a much less exciting tale than its creation.

The Massachusetts section of the book ends with a chapter entitled "Creating the Future," which is devoted to the second Dukakis administration. It details the creation of the second-term Dukakis bureaucracies including the Massachusetts Development Bank, the Bay State Skills Corporation, the Centers of Excellence program, and grass roots Growth Policy Committees. This emphasis on the bureaucratic aspect of state policy lends credence to the politician's notion that economic development is accomplished by political incantation.

Although the majority of their analysis is from a bureaucratic perspective, Ferguson and Ladd reject this incantation approach in their conclusion: "Our analysis of job growth in Massachusetts suggests that statewide economic indicators in Massachusetts are not very different today from what they would have been in the absence of many new state programs and agencies." They find an advantage in the proliferation of agencies, however: "At the same time, political processes that fashioned the initiatives helped foster a political culture that currently allows for smoother resolution of political-economic issues." In short, the hard numbers show the programs to be worthless, but good intentions must be worth something.

It is particularly unfortunate that Ferguson and Ladd did not include the detailed results of their hard analysis in this chapter. The details can be found in their seminal study, "Economic Performance and Economic Development Policy in Massachusetts" (Discussion Paper D82-2, the State-Local Intergovernmental Center, Harvard University). This study, which provides a rigorous statistical test of the importance of state policies in the economic development of the state, shows that firmer conclusions are indeed possible. The authors compared job growth in each industry in Massachusetts with job growth in the same industries nationwide. This enabled them to measure how well Massachusetts would have done if it had only done as well as the nation did as a whole. Any difference between that and the state's actual job growth, they concluded, could be attributed to the performance of state officials.

During Governor Dukakis's first term (from 1975 to 1979), private sector employment in the state rose by 274,000. Had Massachusetts industries done as well as their national counterparts, 353,000 jobs would have been created. The net contribution of state officials therefore amounted to a net loss of 79,000 jobs. The additional bureaucracies were not harmless manifestations of good intentions, they actually reduced the state's performance relative to the nation.

In contrast, the period 1979 to 1983 was one in which Governor Edward King sharply cut back the bureaucracy. Had state industries done as well as their national counterparts, a total of 29,000 jobs would have been created in the Bay State's private sector. A total of 117,000 private sector jobs were actually created in Massachusetts during this period. Thus, the net contribution of state policy during this period was a net gain of 88,000 jobs.

This is the kind of hard data that makes the talk of a miracle sound ridiculous. No such miracle took place. The state's industries grew just as fast as their national counterparts, as above-average performance of the King administration just offset the below-average performance of the Dukakis administration. An analysis of job data since 1983 shows that the state's job creation rate was almost exactly at the rate one would expect given national growth and the mix of industries in Massachusetts.

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The Massachusetts Miracle may have made its mark in the field of political hyperbole, and it launched its greatest believer into national politics. But the common sense judgment of economists and other social scientists still holds. The best thing that state officials can do to help their states develop economically is stay out of the way. Don't overtax. Don't over-regulate. When we succeed in getting that message across to politicians, we can really write books about economic miracles.

Arguing with Success, without Success

Privatization: An Economic Analysis,
by John Vickers and George Yarrow
(MIT Press, 1988), 464 pp.

Reviewed by Sir Alan Walters

This book is one of a series on the regulation of economic activity published by the MIT Press. The first four chapters are devoted to a review of what the authors regard as the relevant theory of incentives, ownership, competition, and regulation. This is a competent survey of the literature, although it appears to contain no new insights. The main contribution of the book is in chapters 5 to 11, which describe and analyze the United Kingdom's privatization program.

It should be noted at the outset that virtually all major elements of Prime Minister Margaret Thatcher's economic reform program have met with mass opposition by academic economists. This is true despite the considerable political and economic success of her program. Privatization is no exception; indeed the success of privatization in Britain is serving as a model for many other countries. So it should not be surprising that Vickers and Yarrow, like other academic economists, have devised theories about why privatization has been a dismal failure and why their prognostications of disaster will be borne out sometime in the future. The book forecasts that "the government is undermining the long-run success of privatization in Britain."

Sir Alan Walters is a senior fellow at the American Enterprise Institute.

On the whole, however, the authors approve of privatization. Oddly enough they do not consider, except in one short paragraph, the biggest and most successful privatization of all, that of public housing being sold to sitting tenants. Instead, the authors examine the conversion of state-controlled corporations into privately controlled corporations. Their complaint is about the way it was done—particularly that shares were sold too cheaply so that wealth was redistributed in the "wrong" way. (Incidentally I will give a prize to anyone who can show me a privatization program where the opposite allegation is made!) They say that the exchequer gave up valuable revenue by selling shares at a discount to small shareholders and workers. Anyone with a knowledge of marketing will see such a criticism as suspect. Ensuring that the shares were bought and held by the workers and small shareholders reduced the probability of renationalization and virtual expropriation by some future (socialist) government. This insurance against future socialist predators enhanced, perhaps greatly, the value of the shares. And if one takes account of the demonstration effects on parallel and future privatization, the advantages of such underpricing become even more apparent. Give-aways maximize. The authors display similar naivete at various other points in their exposition. For example, they argue that one of the main reasons for privatization was to reduce the Public Sector Borrowing Requirement to meet target levels. All those involved, including the Prime Minister, have no such illusions about the difference between public spending and asset sales; we may have been ill-informed, but I do not think any of us were as misguided as the authors so confidently assert.

Vickers' and Yarrow's gravest complaints are leveled against the privatization of the great utilities—British Telecom, British Gas, and British Airports. "Too cheap," of course, but also too much monopoly power left in the hands of the new corporations—monopoly power not suitably curbed by the new regulatory systems. They are right in complaining about the constraints on competition in telecommunications and gas, but their complaints need to be tempered by economic and political realities. For example, the authors clearly think that it would have been better to break up British Telecom along the lines of the American Baby Bells, but they do not mention the cost of doing so. As Mrs. Thatcher's former adviser, I can testify that all the relevant

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ministers, including the Prime Minister, were very keen on such a break-up. But we were eventually convinced that, because of the need to allocate liabilities and assets and prepare separate accounts, such a move would take at least two, perhaps three, years to implement. With the need to search for a new political and economic "window of opportunity," this would have delayed privatization even longer. In the meantime, British Telecom would have remained nationalized. Similarly, having been peripherally involved in the deal that induced the British Telecom competitor, Mercury, to commit itself to sinking a large amount of money to develop a basic network, I find this discussion quite innocent of the central issues. It is also clear today that there is much more competition in telecommunications than was conceivable at the time of transfer of ownership.

Vickers' and Yarrow's big bone of contention is the regulatory system. Their discussion of competition concludes with a *non sequitur*: "where the threat of entry simply does not exist and cannot be made to exist, direct regulation of the dominant firm is then required." After a very long discussion of the theory of regulation of private industries, they offer only a general outline of the government's administration of the nationalized industries. Even more surprising is the fact that the authors, who place such faith in regulation, do not discuss the actual *consequences* of regulatory systems. As many scholars have shown, such as Gilbert Walker in Britain and James Nelson in the United States, regulation in the transport industries over almost 150 years has virtually always had effects opposite to those intended by legislators. This nettle is neither exposed nor grasped. Nor do the authors tell us how well the *covert* system of regulation worked in any of the nationalized industries.

The reader will also find no discussion of the enormous changes in management and administrative structure that precede and accompany privatization. British Telecom, for example, had been run like a government department with cash accounting only and rigid functional lines of responsibility. There is no mention of the reorganization required to equip this behemoth with a modern management structure and suitable internal incentives for efficiency.

Perhaps most surprising is the failure to mention the first great privatization in 1954-56: that of the nationalized trucking industry. This example provides ideal conditions for the study of privatization. The regulatory system remained unchanged for almost 30 years, which is ample time to examine the long-run effects of a change in ownership the authors rightly regard as so important. And since part of the industry (the National Freight Corporation) remained in public ownership until 1982, when it became one of the financially most successful privatizations, cross-section analysis may also be possible.

Another omission is that, rather parochially, the authors do not survey the evidence of the efficacy of privatization in other countries, except for the United States. Such a circumscription of their task is perhaps understandable, although they should have provided references and a summary of this evidence, which, I can testify, had a considerable impact on public sector decision-making.

An innovative aspect of the Thatcher privatizations was the development of a new system of regulating the utilities. The ministers in the Thatcher government were well aware of the gulf between the ideal of regulation and the reality of practical application. In particular they were determined to avoid the absurd waste of having a maximum rate of profit (that is, a 100 percent marginal tax rate above the maximum rate). The minimum intrusion that was politically acceptable was a maximum average-revenue condition applied to a *basket* of services where there was some considerable monopoly power comprising roughly one-half of British Telecom's total value added. This regulation was known as the RPI-X rule (retail price index minus X). In the case of British Telecom, X was set at 3 percentage points, implying that the corporation could increase its (monopoly basket) prices, on the average, by no more than the annual percentage increase in the retail price index minus 3. This rule was set for five years. When it was reset for the next five years, X was raised to 4.5 percentage points, a rather more stringent target. The idea was that by reducing the size of the basket as competition developed (such as phones on a cable network), price controls would eventually be phased out.

The authors are highly critical of this new regulatory arrangement. They assert that it amounts to much the same thing as a maximum rate-of-return system, although I cannot follow the argument by which they reach such a conclusion. The differences, in the short run, have been pointed out by S.C. Littlechild (*Regulation of British Telecommunications*, Report to the Secretary of State, Department of the Treasury,

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February 1983) and, in the long run, by Ingo Vogelsang ("Price Cap Regulation of Telecommunications Services," Rand Corporation, February 1988). The authors also object to the possibility of discrimination within the basket, but the point has been to design an arrangement that allows flexibility instead of imposing the same detailed forms of price control with all their rigidities.

After presenting their criticism, Vickers and Yarrow supply no alternative system of regulation. This is a pity. A system of regulation similar to the RPI-X system is proposed by the Federal Communications Commission, and it would be useful to have a balanced analysis of the options.

In the final analysis, I would commend this book as the most comprehensive account yet published of privatization in Britain. It is most useful as a source book. However, one should pursue many of the authors' arguments further than they do and one should balance their diet with a pinch of the salt of reality of regulatory systems.

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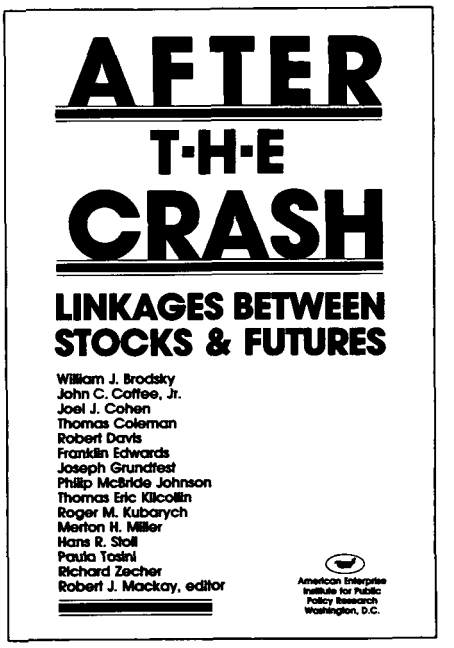

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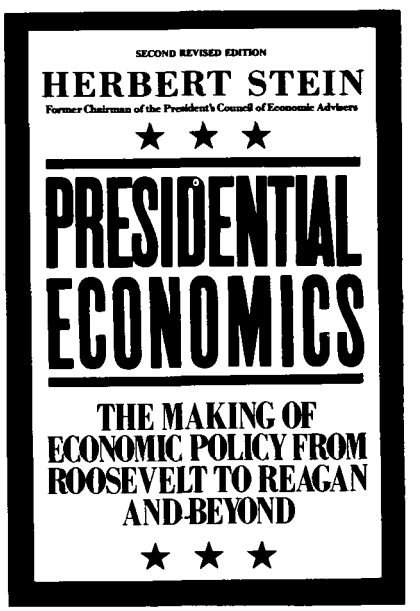
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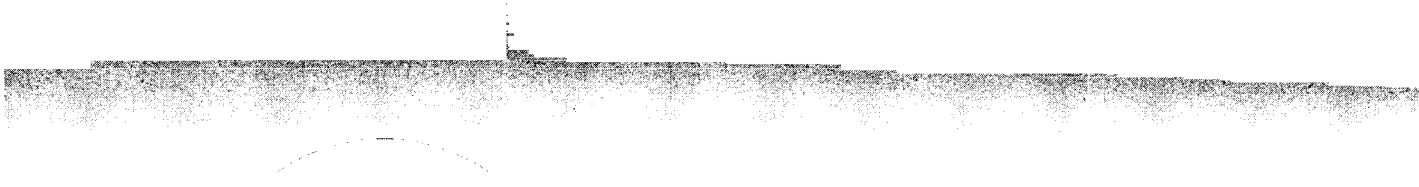

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